83-193

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

RANIER & ASSOCIATES, HARRY
H. RANIER AND ALGIN H. NOLAN,
Petitioners,

vs.

ROBERT H. WALDSCHMIDT, TRUSTEE
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTION PRESENTED

Whether the decision of the United States Court of Appeals for the Sixth Circuit in this case, holding that the judicially-developed "net result rule" is not a valid criterion in determining a preferential transfer in a running-account situation under 11 U.S.C. § 547(b), is incorrect and contrary to the decisions of this court and of other courts of appeals.

PARTIES

In addition to the parties set out in the caption of the case in this court, First Security National Bank of Lexington, Kentucky, and Liberty National Leasing Company were parties

to the appeal before the court of appeals. It is the Petitioners' belief that those two parties have no interest in the outcome of this petition and the Petitioners have so notified the clerk of this court pursuant to Rule 19 of the Supreme Court Rules.

The Petitioners may be referred to in this petition collectively as "Ranier & Associates". The Respondent (the trustee in the Fulghum Construction Corporation bankruptcy) will be referred to as "the Trustee".

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No.

IN THE SUPREME COURT OF THE UNITED STATES

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H. RANIER and ALGIN H. NOLAN,

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Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Ranier & Associates, Harry H. Ranier and Algin H. Nolan petition for a Writ of Certiorari to review the Judgment and Opinion of the United States Court of Appeals for the Sixth

Circuit in this case relative to the preference action and the application of the "net result rule" under 11 U.S.C. § 547(b).

OPINIONS BELOW

The opinion of the court of appeals is reported at 706 F.2d 171 and is reproduced in the Appendix <u>infra</u>, pp. A.1-A.19. The opinion of the United States District Court for the Middle District of Tennessee is reported at 14 B.R. 293 and is reproduced in the Appendix, <u>infra</u>, pp. A.20-A.79. The opinion of the United States Bankruptcy Court for the Middle District of Tennessee is reported at 7 B.R. 629 and is reproduced in the Appendix, <u>infra</u>, pp. A.80-A.175.

JURISDICTION

The judgment of the court of appeals was entered on May 9, 1983. The jurisdiction of this court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of the Bankruptcy Reform Act of 1978 provide as follows:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor--
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;

(4) made--

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer--

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if--

(A) The case were a case under Chapter 7 of this title;

(B) The transfer had not been made; and

(C) such creditor received payment of such

debt to the extent provided by the provisions of this title.

(c) The trustee may not avoid under this section a transfer--

...

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor--

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value of the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11 U.S.C. § 547.

The relevant portions of § 60 of the Bankruptcy Act of 1898, as initially enacted and prior to 1938, are as follows:

a. A person shall be deemed to have given a preference if, being insolvent, he has procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other such creditors of the same class.

b. If a bankrupt shall have given a preference within four months before the filing of a petition, or after the filing of the petition and before the adjudication, and the person receiving it, or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference, it shall be voidable by the trustee and he may recover the property, or its value from such person.

c. If a creditor has been preferred, and afterwards, in good faith, gives the debtor further credit, without security of any kind, for property which becomes a part of the debtor's estates, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be

> set off against the amount which would otherwise be recoverable from him.

Subsequent to 1938, the relevant portions of § 60 read as follows:

> a. (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.
>
> . . .
>
> b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted,

its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: Provided however, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any state court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

c. If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which

would otherwise be recoverable
from him.

STATEMENT OF THE CASE

This case presents a significant question in the law of preferential transfers under the Bankruptcy Reform Act of 1978.

An involuntary petition was filed in the United States Bankruptcy Court for the Middle District of Tennessee against Fulghum Construction Corporation ("Fulghum") on January 25, 1980. An order for relief was entered on March 17, 1980.

On February 6, 1980, this adversary proceeding was filed by the Trustee against Ranier & Associates to, *inter alia*, avoid as preferential transfers certain monetary transactions

which occurred between Fulghum and Ranier & Associates in 1978 and 1979. Jurisdiction was invoked pursuant to 28 U.S.C. § 1471.

The facts shown at the trial, which was held on May 22 and 23, 1980, that are relevant to the question presented to this court, are as follows: Fulghum was a pipeline construction firm. Ranier & Associates was a Kentucky general partnership, consisting of Harry H. Ranier and Algin H. Nolan. In October, 1977, all of the common stock of Fulghum was purchased by Harry Ranier and his cousin, Neale Hall. Subsequently, Ranier & Associates succeeded to a 100% ownership of the stock and Ranier and Nolan became officers in the corporation.

In the latter part of 1978 and in 1979, in order to help meet the short-term cash flow requirements of Fulghum, Ranier & Associates made temporary advances on an ongoing basis to the corporation. Most of the transactions occurred beginning in May, 1979, after (because of Ranier & Associates' efforts to rehabilitate the company) Fulghum obtained four jobs, which required substantial cash. In the typical transaction, after being informed that Fulghum required cash on a short-term basis (usually to cover payroll), and the corporation was expecting imminent receipt of payment on its accounts receivable sufficient to reimburse any advance of funds, Ranier & Associates would advance funds

and would be reimbursed for some or all of the advance when the payments on accounts receivable were received by the corporation. Over this period of time and up to (and in one instance after) the filing of the voluntary petition, there were approximately 100 such transactions between Ranier & Associates and Fulghum, the net result being that Ranier & Associates advanced to Fulghum, and thereby enriched the bankruptcy estate, in excess of $380,000.00 more than Fulghum paid to Ranier & Associates during that period.

On November 28, 1980, a Judgment and Memorandum were entered in which the bankruptcy court held that these monetary transactions which the Trustee sought to avoid were not preferential

transfers and dismissed the Trustee's complaint relative to the preference action. The bankruptcy court reasoned that in order to determine whether, in a running-account situation as is present in this case, the Trustee had met his burden of proving the element of a voidable preference contained in § 547(b)(5), one must look at the net result of all of the transactions taken as a whole and, if the net result is to enrich rather than deplete the estate, there is no preference (and thus no necessity to apply § 547(c)(4), which comes into play only if there is a transfer which satisfies § 547(b)). The bankruptcy court expressly followed several decisions of this court and other courts of appeals which

formulated and applied this "net result rule" in determining whether there was a preferential transfer under § 60a of the prior bankruptcy law. The bankruptcy court, examining the language and legislative history relative to § 547, and specifically § 547(c)(4), noted no legislative intent to overturn or change the law as set out in the previous cases which so applied the "net result rule".

On appeal by the Trustee to the United States District Court for the Middle District of Tennessee, the district court, concluding that the bankruptcy court correctly applied the "net result rule", affirmed the decision of the bankruptcy court.

The Trustee appealed to the United States Court of Appeals for the Sixth Circuit from the decision of the district court and, on May 9, 1983, the sixth circuit reversed relative to the preference action, and specifically the application of the "net result rule", reasoning that the application of the "net result rule", in determining whether § 547(b)(5) has been satisfied, "vitiates the congressional intent clearly reflected both on the face of § 547 and in the legislative history of the enactment". The sixth circuit grounded this reasoning on its observations that such an application of the "net result rule" "would render the defense incorporated in § 547(c)(4) impotent"; would be contrary to the

wording of § 547(b) which "deliberately defines a preference as a 'transfer', rather than as an aggregate of transfers or netting of transactions between the creditor and debtor"; and is not supported by the legislative history of § 547. The sixth circuit remanded the case for further proceedings consistent with its opinion relative to the preference action. [1]

REASONS FOR GRANTING THIS PETITION

This petition should be granted because the opinion of the sixth circuit in this case relative to the "net result rule" conflicts with decisions of this court and other courts of appeals.

There are several decisions of this court and other courts of appeals in which the "net result rule" was applied to determine whether there was a preferential transfer under § 60a of the Bankruptcy Act of 1898, which was the predecessor to 11 U.S.C. § 547(b). These cases were expressly followed by the bankruptcy court and the district court in this case and are cited and thoroughly discussed in the opinions of those courts. (Appendix, infra, pp. A.53-A.76, and A.125-A.167.) These cases applying the "net result rule" recognized and were premised upon the view that a running-account situation merits special consideration and to isolate each transaction, rather than to look at the net result of all of the

transactions together, would be inequitable and inconsistent with the policy of not discouraging extensions of credit on an ongoing basis to a struggling debtor. See, e.g. Jaquith v. Alden, 189 U.S. 78, 82-3 (1909); Taylor, Section 60c of the Bankruptcy Act; Inadequate Protection for the Running-Account Creditor, 24 Vand. L. Rev. 919 (1970-71).

The sixth circuit erred in apparently concluding that these cases, and therefore the "net result rule" and its application in initially determining the existence of a preferential transfer, no longer have viability under § 547.[2] The wording of § 547, upon which the sixth circuit relied in reaching that conclusion, is in

relevant part similar to the wording of corresponding portions of § 60 of the prior law, which was applicable at the time of the decisions of this court and other courts of appeals which the bankruptcy court and district court followed in this case. As indicated by the legislative history of § 547(c)(4) quoted by the sixth circuit (Appendix, infra, p. A.13), § 547(c)(4) is similar to and is a recodification of § 60c of the prior law. Therefore, even assuming that the sixth circuit were correct in its conclusion that the application of the "net result rule" in conjunction with § 547(b)(5) would make § 547(c)(4) "impotent", the same would have been true of § 60c in the decisions under prior bankruptcy law and that is no

ground for determining that the viablity of the "net result rule", as a criterion for determining a preferential transfer, has been affected by the passage of § 547. However, the sixth circuit, in concluding that the application of the "net result rule" would render § 547(c)(4) "impotent", overlooked the fact that the "net result rule", normally, has only been applied to a running-account situation in which a number of transactions were involved. Therefore, § 547(c)(4) would have continued viability in those cases where the nature or number of transactions involved is insufficient to equitably merit the application of the "net result rule" relative to § 547(b)(5).

In addition, § 60a of the prior law, as the sixth circuit noted of § 547(b), also defined a preference as a "transfer", rather than expressly as an aggregate of transfers or netting of transactions. Therefore, there is also no justification for the sixth circuit's conclusion that this wording of § 547 indicates a legislative attempt to vitiate the "net result rule" developed in the case law relative to § 60a.

Likewise, the sixth circuit's reliance upon the legislative history of § 547 appears to be misplaced. As noted by the bankruptcy court below, the legislative history, which was cited by the sixth circuit, at most, says nothing about whether Congress

intended to affect or overturn the "net result rule" cases dealing with § 60a which were followed by the bankruptcy court and district court. (Appendix, <u>infra</u>, pp. A.13, A.163-64). Rather, the legislative history of § 547(c)(4) simply indicates that it is a recodification of § 60c, referring to it as a "net result rule" also, and makes no mention of, and has no effect on, the "net result rule" formulated by the cases in connection with § 60a and the initial determination of the existence of a preferential transfer.

CONCLUSION

The passage of 11 U.S.C. § 547 has not affected the viability of the "net result rule" in determining whether there has been a preferential transfer in a running-account situation; and the sixth circuit opinion in this case is contrary to decisions of this court and other courts of appeals. Therefore, this petition should be granted.

Respectfully submitted,

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FOOTNOTES

1/ The fact that the sixth circuit's judgment in this case may not be final and the case has been remanded for further proceedings does not prevent this court from granting this petition at this time. Hamilton-Brown Shoe Co. v. Wolf Bros. & Co., 240 U.S. 251, 258-59 (1916); Forsyth v. Hammond, 166 U.S. 506, 511-15 (1897); 12 Moore's Fed. Prac. ¶434.01 (2d ed 1982); Annot. 53 L.Ed 711, 713-14, supp. by 61 L.Ed. 409.

2/ Two other appellate decisions under § 547 were found with holdings consistent with that of the sixth circuit in this case. See In re Wadsworth Building Components, Inc., No. 82-3189 (9th Cir. July 1, 1983) and In re Gold Coast Seed Co., BAP No. NC-82-1447 EVAs, Bankr. No. 4-80-02038-HN, Adv. No. 4-80-0485-AW (9th Cir. Bankr. App. Panel June 21, 1983).

APPENDIX

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Nos. 81-5779, 81-5801

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

IN RE: FULGHUM
CONSTRUCTION
CORPORATION,

Debtor,

ROBERT WALD-
SCHMIDT, TRUSTEE,

Plaintiff-
Appellant,
Cross-Appellee,

v.

HARRY RANIER,
ALGIN NOLAN and
RANIER &
ASSOCIATES,

Defendants-
Appellees,
Cross-
Appellants,

ON APPEAL from the
United States District
Court for the Middle
District of Tennessee

FIRST SECURITY)
NATIONAL BANK)
OF LEXINGTON and)
LIBERTY NATIONAL)
LEASING COMPANY,)
)
Defendants-)
Appellees.)

Decided and Filed May 9, 1983

Before: CONTIE and KRUPANSKY, Circuit Judges; and CELEBREZZE, Senior Circuit Judge.

KRUPANSKY, J. This action joins inquiry into the long-standing judicially evolved application of the "net result rule" as the criteria for determining a preferential transfer as defined in 11 U.S.C. §547 of the Bankruptcy Reform Act of 1978. An involuntary petition in bankruptcy was filed

against Fulghum Construction Corporation (Fulghum) whereupon the trustee initiated the instant proceeding to, _inter alia_, avoid as preferential transfers certain monetary transactions which transpired between Fulghum and its sole shareholder, Ranier & Associates (Ranier), during the one year period immediately preceding the filing of the bankruptcy petition. Both the bankruptcy court and reviewing district court adjudged that application of the net result rule, incorporated into 11 U.S.C. § 547(b)(5) as a judicial gloss, foreclosed a finding that the transfers were preferential. See: _In re Fulghum Construction Corp._, 7 B.R. 629 (Bankr. M.D. Tenn. 1980); _In re Fulghum_

Construction Corp., 14 B.R. 293 (M.D. Tenn. 1981). The operative facts, detailed in the lower courts' opinions, disclose that approximately 100 transactions occurred between Ranier and Fulghum during the year immediately preceding the filing of the bankruptcy petition. The aggregate amount of the payments by Ranier to Fulghum exceeded the aggregate amount of the payments tendered by Fulgham (sic) to Ranier during this period and the value of the estate was accordingly appreciated.

Preferential transfers which may be avoided by the trustee are defined in 11 U.S.C. § 547(b):

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor-

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owned by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made -

(A) on or within 90 days before the date of filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer -

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if -

> (A) the case were a case under Chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provision of this title.

As is facially evident from this provision, all five enumerated criteria must be satisfied before a trustee may avoid any transfer of property as a preference. _See_: _In re Bishop_, 17 B.R. 180, 181-82 (Bankr. N.D. Ga. 1982). Section 547(b) is proscribed by its own terms to the numerous "defenses" available to creditors which appear in § 547(c) and which, if applicable, preclude the trustee from avoiding the § 547(b) preferential

transfer. Particularly, § 547(c)(4) provides:

> (c) The trustee may not avoid under this section a transfer -
>
> * * *
>
> > (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor -
> >
> > > (A) not secured by an otherwise unavoidable security interest; and
> > >
> > > (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor

Section 547(c)(4) is perhaps most accurately characterized as a "subsequent advance rule". Preferential transfers as defined in § 547(b) may not be avoided by the trustee if "<u>after</u> such

transfer, such creditor gave new value". _Id._ _See_: _In re Bishop_, _supra_; _In re Garland_, 19 B.R. 920 (Bankr. E.D. Mo. 1982); _In re Rustia_, 20 B.R. 131, 135 (Bankr. S.D. N.Y. 1982); _In re Fabric Buys of Jericho_, 22 B.R. 1013, 1016-17 (Bankr. S.D. N.Y. 1982); _In re Hersman_, 20 B.R. 569 (Bankr. N.D. Ohio 1982).

In the action _sub judice_, the district court adjudged, and the parties do not dispute on appeal, that the criteria of § 547(b)(1) through (b)(4) have been satisfied. In addressing the application of § 547(b)(5) to the facts of the case at bar, however, the district court relied upon its equitable powers to justify its application of the net result with the following rationale:

> [T]his Court must agree with the Bankruptcy Court that two "net result rules" actually exist in bankruptcy law. One, that of section 547(c)(4) and insisted upon by the trustee, is statutory. The other, that applied by the Bankruptcy Court, is nonstatutory, a judicial gloss upon the requirements of section 547(b).

14 B.R. at 303. Applying the net result rule as a condition implicitly incorporated into § 547(b)(5) and, correspondingly, a threshold requirement to support a preferential transfer, the district court observed that the net effect of all the transactions between the debtor, Fulghum, and the creditor, Ranier, appreciated the value of the estate and, accordingly, the transfers could not be avoided by the trustee as preferences. Upon concluding that no preferential transfers existed it was

unnecessary for the district court to identify the defenses available to the creditor under § 547(c).

The net result rule is a judicially created doctrine, predicated upon principles of equity, which evolved shortly after the enactment of the Bankruptcy Act of 1898 to presumably rectify what was judicially perceived to be inequities in bankruptcy law. See: In re Garland, supra, 19 B.R. at 922-25 (artfully documenting development of this doctrime); In re Bishop supra, 17 B.R. at 183-85 (same). As an equitable doctrine its application, of necessity, must "comport to and remain compatable with the prevailing legislative intent". In re Bell, 700 F.2d 1053, 1057 (6th Cir. 1983);

United States v. Killoren, 119 F.2d 364, 366 (8th Cir. 1941). Logic dictates that judicial interposition of the net result rule into § 547(b)(5) vitiates the congressional intent clearly reflected both on the fact of § 547 and in the legislative history of the enactment.

Since the net result rule is "broader" in scope than the subsequent advance rule of § 547(c)(4), engrafting the former doctrine upon § 547(b)(5) as a threshold requirement for the qualifying preference would render the defense incorporated in § 547(c)(4) impotent. The broader scope of the net result rule permits its utilization by the creditor irrespective of whether the value furnished by the creditor to

the debtor is advanced either before or after the transfer from the debtor to the creditor. Contrawise, the subsequent advance rule of § 547(c)(4) is more circumscribed in application and forecloses avoidance of the transfer by the trustee only if the creditor provides additional value after the transfer from the debtor to the creditor.[1] A "judicial gloss" which significantly restricts the statutory definition of "preference" and pragmatically emasculates the creditor defense thereto as intended by Contress in § 547(c)(4) constitutes nothing less than legislation by judicial decree.

Moreover, judicial interposition of the net result rule into § 547(b)(5) finds no sanction in the legislative

history of the Bankruptcy Reform Act of 1978. The legislative proceedings attendant to the promulgation of § 547(b)(5) are significantly devoid of any allusion to the net result rule. Contrawise, the House Report discussion the subsequent advance rule, § 547(c)(4), incorporates concise language reflecting the intent of Congress:

> The fourth exception [§ 547(c)(4)] codifies the net result rule in section 60c of current law. If the creditor and the debtor have more than one exchange during the 90-day period, the exchanges are <u>netted out according to the formula in paragraph (4)</u>. Any new value that the creditor advances must be unsecured in order for it to qualify under this exception. (Emphasis added).

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 374, reprinted in 1978 U.S. Code

Cong. & Ad. News 5787, 6330. The Senate Report is identical. S. Rep. No. 95-989,95th Cong., 2d Sess. 88, reprinted in 1978 U.S. Code Cong. & Ad. News. 5874. Thus, it would appear that the "net result rule" is an anachronism of § 547(c). As has been noted,

> Whatever the net result rule may have been under the prior Bankruptcy Act, Congress has indicated that, under the Bankruptcy Code, the rule is to be applied accordingly to the formula set forth in § 547(c)(4).

In re Garland, supra, 19 B.R. at 926. Congressional metamorphasis has transformed the judicially created net result rule into what may be charactized as a subsequent advance rule and has codified this augmented version into § 547(c)(4) rather than § 547(b)(5). See also: In re Bishop,

supra, referencing: 2 Norton Bankr. L. & Prac. §32.20 (net result rule "is of doubtful current validity"); 4 Collier on Bankruptcy § 547.40 (seriously questioning continuing vitality of the net result rule in the wake of the Bankruptcy Reform Act of 1978); Report of the Commission on the Bankruptcy Laws of the United States, H.Doc.No. 93-137, 93rd Cong., 1st Sess., Pt. 1, 210-211 (1973) ("A true 'net result' rule would total all payments and all advances and offset the one against the other. This is not allowed under the Commission's recommendation, since the advance to be offset must be subsequent to the preference.")

Section 547(b) deliberately defines a preference as a "transfer",

rather than as an aggregate of transfers or netting of transactions between the creditor and debtor, and § 547(c) artfully articulates equitable "defenses" whereby the trustee may be foreclosed from avoiding the preference. In particular, § 547(c)(4) permits a netting procedure to be applied when the debtor and creditor are both recipients and initiators of transactions. Construed _in pari materia_, § 547(b) and (c) disclose a calculated legislative scheme and intent to implement equitable considerations which the judiciary at the turn of this century adjudged as lacking and responded by evolving the net result rule. This legislative response reflected in the promulgation of

§ 547(b) and particularly § 547(c)(4) mirror the congressional version of equitable principles, expressed as the subsequent advance rule, to be incorporated into the 1978 revision of the Bankruptcy Act.

Accordingly, the judgment of the district court dismissing the trustee's complaint to avoid transfers from Fulghum to Ranier as preferential is hereby VACATED and this case is REMANDED for further proceedings consistent with this opinion. The judgment of the district court is AFFIRMED in all other respects, including the dismissal of (1)the trustee's amended complaint seeking to set aside the sale of construction equipment, and seeking to pierce Fulghum's corporate veil and (2)

Ranier's claim for damages arising from the trustee's alleged improper retention of construction equipment, for the reasons articulated in the district court's memorandum opinion.

FOOTNOTES

1/ Bankruptcy Judge Robert Bauer appears to have recognized this dilemma:

> I can think of no set of facts where, if the net result rule were to be applied under section 547(c)(5), 547(c)(4) would ever be utilized.
>
> In re Garland, supra, 19 B.R. at 926.

IN THE UNITED DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE
NASHVILLE DIVISION

IN RE:	)	
	)	
FULGHUM CONSTRUCTION CORPORATION,	)	NO. 81-3040
	)	

M E M O R A N D U M

This action is an appeal by the bankruptcy trustee from two judgments entered by the United States Bankruptcy Court, In re Fulghum Construction Co., 7 B.R. 629 (Bkcy. Ct. M.D. Tenn. 1980) and In re Fulghum Construction Co., No. 380-00235, Adv. Proc. No. 380-0081 (Bkcy. Ct. M.D. Tenn. July 14, 1980), Hon. Russell H. Hippe, Jr., presiding, dismissing the trustee's complaint in the proceeding below. Also involved in

this action is an appeal by defendant Ranier & Associates from the dismissal of a counterclaim for damages filed by it against the trustee.

In this appeal the trustee argues that the Bankruptcy Court erred in its conclusions (1) that the trustee had no interest in certain equipment sold by the debtor, Fulghum Construction Company, to one of the defendants, Ranier & Associates; (2) that the corporate entity should not be disregarded and therefore that defendant Ranier & Associates--the sole shareholder of the debtor--should not be held liable for the debtor's debts; and (3) that certain payments made by the debtor to defendant Ranier & Associates were not preferential transfers under section

547(b) of the Bankruptcy Code. Ranier & Associates in turn challenges the conclusion of the Bankruptcy Court that it failed to substantiate its claim for damages that it allegedly suffered because of the trustee's retention of the above-mentioned equipment.

For the reasons stated in this opinion, the appeals of both parties are dismissed and the judgment of the Bankruptcy Court is affirmed in all respects.

Applicable Law

The Bankruptcy Court found that the law of Texas, the state of the debtor's incorporation, was controlling on the issues of whether the corporate veil should be pierced and whether the

transfer of the equipment from the debt Ranier & Associates was a valid sale. This finding is not disputed, and this Court agrees that Texas law is applicable. See Restatement (Second) of Conflicts § 302 (1971).

Facts

The Bankruptcy Court made the following findings of fact in the proceeding below. Because these findings are not clearly erroneous, they are adopted by this Court and herein repeated. See Rule 810, Rules of Bankruptcy Procedure.

> 1. The corporation was organized in Houston, Texas in 1966. It was named Fulghum Engineering & Construction, Inc., for one of its organizers, James T. Fulghum, who served as the corporation's president. The name was later changed to Fulghum Construction Corporation.

2. The corporate was authorized to engage in a wide variety of heavy construction activities but at all times material hereto engaged principally in the construction of oil and natural gas pipelines. It was authorized to do business in some thirty states and Canada. At all times material hereto its principal place of business was in the vacinity [sic] of Nashville, Tennessee.

3. In October 1977, Harry H. Ranier and Neale R. Hall, residents of Kentucky, acquired all of the outstanding shares of stock in the corporation. Although Ranier and Hall became vice-presidents of the corporation, no significant changes in management were made at that time. Mr. Fulghum, who continued to serve as president, testified that it was his understanding that the new owners were going to infuse the corporation with additional capital, because substantial liquid assets were required for such companies to bid successfully on large projects.

4. The corporate lost in excess of $600,000 from its operations during 1977.

5. In the early part of 1978, Ranier formed a general

partnership with a certified public accountant, Algin H. Nolan, known as Ranier & Associates. Since July of that year, when Hall transferred all of his stock to Ranier, Ranier & Associates has been the corporation's sole shareholder.

6. The shareholder expressed dissatisfaction with the management of the corporation at a meeting in April 1978. On July 15, 1978, Mr. Fulghum and another key member of the management team were discharged. Both the shareholder and the directors adopted resolutions authorizing Nolan

> to assume full and complete management and administrative responsibilities of the Corporation with full power to remove and/ or replace any and all personnel thereof, to reorganize in any fashion or cease altogether any or all operations of the Corporation, including dissolutionment, as he in his sole discretion may deem necessary, proper, or expedient.

A few days later a new board of directors elected Michael J. Leatherman executive vice-president to assume responsibility for soliciting bids for the corporation and for overseeing the company's operations. These were the last significant formal actions taken by the shareholder or the directors of the corporation prior to the filing of the trustee's complaint.

7. The first steps taken by Nolan pursuant to the extraordinary powers granted him in the shareholder's and directors' resolutions occurred in September 1978. For the stated purpose of improving both the balance sheet and the liquidity of the corporation, he decided that all of the corporation's equipment should be sold to the shareholder and then be leased back to the corporation. The equipment was appraised at $1,137,350. To effect this sale and leaseback, two uncaptioned agreements were executed by the shareholder and the corporation on or about September 20, 1978. One of the agreements recited that the shareholder as buyer had paid to the corporation as seller of the equipment the cash purchase price of $1,137,350. In the other, the shareholder purported to lease the equipment back to the corporation.

The sale agreement contained no language of conveyance. Neither the shareholder nor the corporation took any formal steps to consummate the sale. No bill of sale was ever executed, and none of the documents evidencing ownership of the equipment (e.g., files maintained by the corporation on each item of equipment that included the original bill of sale and other pertinent documents) were ever transferred from the corporation to the shareholder. Several items of equipment were covered by certificates of title issued by the state of Tennessee. None of the title certificates were ever transferred to the shareholder. The corporation remained in possession of all of the equipment.

8. Although the so-called sale agreement recited that the corporation received $1,137,350 in cash, that recitation was false. The shareholder obtained a loan in the amount of $950,000 from one of the defendants, Liberty National Leasing Company (a subsidiary of Liberty National Bank), to finance the major portion of the purchase price and initially only paid this sum to the corporation. Coincidental with this transaction, Nolan transferred the corporation's principal bank accounts

from a Nashville bank to one in Mt. Sterling, Kentucky, where Ranier & Associates had its office. Apparently a check in the amount of $1,137,350 was deposited in one of the corporation's newly opened accounts. On the same date, however, a check drawn on that account in the amount of the difference between the Liberty National loan and the purchase price--$185,350--was deposited in one of the shareholder's accounts. These checks apparently were paid on the same date. Thus only $950,000 was actually paid to the corporation in September 1978.

9. Nolan testified at the trial that the $185,350 was withdrawn from the corporation's account in order to safeguard it against a possible unauthorized withdrawal. He indicated that Mr. Fulghum had made such a withdrawal some months before. Mr. Fulghum, however, had been dismissed more than two months earlier. The court thus finds that Nolan's explanation of the withdrawal was patently false. It is apparent that the shareholder had no intention of paying the full cash purchase price in September 1978 but intended only to advance to the corporation the proceeds of the Liberty National loan.

10. A corporate balance sheet prepared by an accounting firm immediately after the September 1978 transaction reflected a shareholder's equity of $170,928.00. Prior to the purported sale, the equipment was carried on the corporation's books at the depreciated value of $436,258.00. Thereafter the corporation never represented in its financial records that it continued to own the equipment.

11. While the transaction resulted in an improvement in the corporation's balance sheet and liquidity, it was detrimental to the corporation in that it resulted in a significant taxable gain and necessitated the dissipation of a valuable asset -- the tax loss carry-forward -- to avoid payment of the substantial tax liability that resulted. The real beneficiary appears to have been the shareholder, which was able to depreciate the equipment from the new, stepped-up basis. While the loan proceeds provided the corporation with additional cash, there was no showing why the corporation itself could not have borrowed this amount of money, using the equipment as collateral as the shareholder did.

12. The shareholder granted Liberty National a security interest in the equipment to secure repayment of this loan.

13. According to a detailed analysis prepared by Nolan, a substantial number of financial transactions between the corporation and the shareholder took place between June 1978 and November 1979. It was the shareholder's practice to withdraw from the corporation, as well as other corporations it owned, any cash that was not immediately required by the corporation and to return it on an as-needed basis. According to this analysis, which was never seriously questioned by the trustee, there were almost one hundred such transactions during this period of time. Initially the corporation was indebted to the shareholder, but as a result of the $187,350 credit from the equipment transaction, the shareholder became indebted to the corporation and remained so until June 1979. From that time until the corporation ceased doing business in November 1979, the corporation was indebted to the shareholder for advances made to it. The net result is that the corporation presently is indebted to the shareholder in the sum of $387,844.16. Most of the advances

made by the shareholder in the latter part of 1979 were in the form of deposits to the corporation's payroll account at the Kentucky bank to ensure completion of jobs in progress.

14. Although there were a substantial number of financial transactions between the shareholder and the corporation, it appears that Nolan, who rigidly controlled the corporation's finances at least after September 1978, maintained detailed records separating the financial affairs of the partnership and the corporation.

15. In May 1979 the shareholder borrowed substantial sums of money from another of the defendants, First Security National Bank of Lexington. As part of the security therefor, Ranier & Associates granted the bank a security interest in the equipment. It is conceded by the trustee that the sums owed to both secured party defendants substantially exceed the present value of the equipment and that, if their security interests are valid, he has no interest in the equipment.

16. On January 25, 1980, an involuntary petition was filed against the corporation in this

court, and an order for relief subsequently was entered.

The Sale of the Equipment

The trustee challenges the validity of the equipment transfer from Fulghum Construction Company to Ranier & Associates on two grounds. First, the trustee argues that because of certain improprieties in the sales transaction itself, title to the equipment never passed to Ranier & Associates. Alternatively, the trustee argues that even if title passed, the sale should be set aside as fraudulent. This Court rejects both these contentions and agrees with the Bankruptcy Court that title to the equipment passed to Ranier & Associates upon full payment of the purchase price.

The trustee's initial argument is that title to the equipment did not pass because no formal bill of sale was ever executed and no actual transfer of the certificates of title to certain pieces of the equipment occurred. This argument must fail for the simple reason that the failure to transfer these documents does not prevent transfer of the title itself. As the Bankruptcy Court correctly ruled, the transaction in question here is governed by section 2-401(3)(b) of the Uniform Commercial Code, which provision has been adopted by all three states concerned here (Texas, Tennessee, and Kentucky). That provision states:

Each provision of this chapter with regard to the rights, obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods except where the provision refers to such title. Insofar as situations are not covered by the other provisions of this chapter and matters concerning title become material the following rules apply:

(3) Unless otherwise explicitly agreed where delivery is to be made without moving the goods:

(b) if the goods are at the time of contracting already identified and no documents are to be delivered, title passes at the time and place of contracting.

The pertinent case law under this section demonstrates clearly that the crucial consideration in determining passage of title is not the transfer of a certificate of title but the completion of all performance intended to

occur by the parties to the contract. _See_ _Young v. Golden State Bank_, 560 P.2d 855 (Colo. App. 1977); _Ace Supply, Inc. v. Rocky-Mountain Machinery Co._, 525 P.2d 965 (Idaho 1974); _Southwest Bank v. Moritz_, 23 Neb. 45 (1979). _See also_ _Wood Chevrolet Co., Inc. v. Bank of Southeast_, 352 So.2d 1350 (Ala. 1977); _International Harvester Credit Corp. v. Associates Financial Services Co., Inc._, 211 S.E.2d 430 (Ga. 1974); _Seigel v. Giant Foods, Inc._, 318 A.2d 874 (Md. App. 1974); _National Exchange Bank v. Mann_, 260 N.W.2d 716 (Wis. 1978). Clearly, the parties in this case intended that title to the equipment would pass upon payment of the purchase price. Once Ranier & Associates paid

the outstanding amount of that price, it acquired title to the equipment. Moreover, after the final payment was made, the equipment was no longer listed as an asset by Fulghum Construction Company on its records. Instead, Ranier & Associates listed the equipment as its assets and proceeded to lease the equipment to Fulghum. It is irrelevant that Ranier & Associates did not take physical possession of the equipment because no such transfer of physical possession was intended by the parties to occur. Additionally, contrary to the trustee's contention, it is unimportant that the Tennessee motor vehicle statute, T.C.A. § 55-3-118, may state that a certificate of title must be transferred to transfer the

title itself. Non-delivery of a certificate of title does not prevent the effective passage of title from teh seller to the buyer under section 2-401, even when a state's certificate of title act provides that no title can be acquired until the certificate has been issued or delivered. _See_, _e.g._, _Wood Chevrolet Co., Inc. v. Bank of Southeast_, 352 So.2d 1350 (Ala. 1977). Section 2-401 governs such transactions, and the title passes without the need for a formal certificate or other document indicating transfer of title.

As this Court concludes that title to the equipment did pass to Ranier & Associates, the trustee would have this Court declare the transaction void as fraudulent. The trustee presents two

bases for his position: (1) there was no formal vote of approval of the sale by the shareholders or Fulghum Construction Company, and (2) the sale was allegedly in breach of a fiduciary duty owed by Ranier & Associates to the creditors of Fulghum Construction Company. In support of his initial argument the trustee relies upon the Texas Business Corporation Act, which states in relevant part that any sale of "all or substantially all" of a corporation's assets must be authorized by a formal vote of the corporation's shareholders. The trustee argues that because Ranier & Associates was not in literal compliance with that provision, the sale of equipment is void.

To accept the trustee's position would be to defy common sense. Ranier & Associates was the only shareholder of Fulghum Construction Company, and it was Ranier & Associates who authorized and carried out the equipment sales transaction. The Bankruptcy Court noted correctly that the purpose of the consent provision of the Texas Act, like other similar statutes, is to protect the interests of minority shareholders. Because no minority shareholders exist in this case, it would serve no purpose to require Ranier & Associates to comply strictly with the Act. To be in compliance under the trustee's theory, Ranier & Associates would have had to vote a recommendation of the transaction, give

notice to itself of the recommendation and of a meeting to vote on the recommendation and then at the meeting vote approval of the deal. Clearly, as the Bankruptcy Court concluded, bringing about this sort of charade was not the intent of the Act.

The trustee's second contention has greater merit than his statutory argument, but it too must fail. The trustee argues that Ranier & Associates breached a fiduciary duty to the creditors of Fulghum Construction Company in authorizing and performing the sale of equipment. This Court agrees with the trustee that the controlling shareholder--and in this case the sole shareholder--of a corporation maintains a fiduciary obligation to not only the

minority shareholders but also the creditors of the corporation. See Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939). This Court also agrees with the trustee that a transaction between a controlling shareholder and a corporation, such as the one in question here, is to be given a higher degree of scrutiny than other contracts. See 13 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 5834, 5837 (rev. ed. 1970). Examining the equipment sale transaction with even this higher degree of scrutiny, however, this Court still concludes that Ranier & Associates did not breach its duty to the creditors.

The trustee argues that by selling the equipment Ranier & Associates

deprived Fulghum Construction Company of valuable assets that would have enabled the company to secure capital under supposedly better conditions than the outright sale provided. This argument is not supported by the facts. Fulghum Construction Company was in dire financial condition at the time Ranier & Associates acquired it. Because of its poor financial position the company was in need of a large infusion of capital. A feasible approach to secure this capital was to have Ranier & Associates acquire financing for the company, and this it did by granting to the defendant lending institutions a security interest in the equipment. Although Ranier & Associates did gain some benefit from the

sale, the facts are simply not sufficient to support a finding that the end result was so detrimental to the company that Ranier & Associates somehow breached its fiduciary obligation to either the company or the company's creditors.

For the above reasons, this Court agrees with the Bankruptcy Court that the trustee has no interest in the equipment. The conclusion of the Bankruptcy Court is affirmed.

Disregarding the Corporate Entity

The trustee appeals from the ruling of the Bankruptcy Court that the corporate entity of Fulghum Construction Company should not be disregarded and therefore that the defendant Ranier

& Associates is not liable for the company's debts. For the reasons stated below, this Court rejects the trustee's effort and affirms the Bankruptcy Court's decision.

As the Bankruptcy Court correctly related, under Texas law the corporate entity should be disregarded only as an extraordinary remedy under extreme conditions. The corporate veil has been pierced only in such dire cases as when the corporate fiction has been utilized to defraud existing creditors, to evade an existing obligation, to circumvent a statute, to achieve or perpetuate a monopoly, or to protect the commission of crimes. See Pace Corp. v. Jackson, 284 S.W.2d 340 (Tex. 1955); Roylex, Inc. v. Langson Bros.

Construction Co., 585 S.W.2d 768 (Tex. Civ. App. 1979); William B. Roberts, Inc. v. McDrilling Co., 579 S.W.2d 335 (Tex. Civ. App. 1979); Tigrett v. Pointer, 580 S.W.2d 375 (Tex. Civ. App. 1978); Angus v. Air Coils, Inc., 567 S.W.2d 931 (Tex. Civ. App. 1978); Holmes v. Clow, 533 S.W.2d 99 (Tex. Civ. App. 1976); Minchen v. Van Trease, 425 S.W.2d 435 (Tex. Civ. App. 1968); Radio KBUY, Inc. v. Lieurance, 390 S.W.2d 16 (Tex. Civ. App. 1965). From an examination of the facts set forth previously, it is apparent that none of these conditions exist in this case.

The Texas courts have established a two-part test to determine whether the corporate entity should be disregarded. First, the complaining party

must demonstrate fraud and a lack of good faith on the part of the controlling shareholder. Roylex, Inc. v. Langson Bros. Construction Co., 585 S.W2d 768 (Tex. Civ. App. 1979); William B. Roberts, Inc. v. McDrilling Co., 579 S.W.2d 335 (Tex. Civ. App. 1979); Hanson Southwest Corp. v. Dal-Mac Construction Co., 554 S.W.2d 712 (Tex. Civ. App. 1977); Holmes V. Clow, 533 S.W.2d 99 (Tex. Civ. App. 1976); Radio KBUY, Inc. v. Lieurance, 390 S.W.2d 16 (Tex. Civ. App. 1965). Second, the complaining party must show a degree of stockholder control that the corporation retains no separate corporate interests of its own. Angus v. Air Coils, Inc., 567 S.W.2d 931 (Tex. Civ. App. 1978); Hanson Southwest

Corp. v. Dal-Mac Construction Co., 554 S.W.2d 712 (Tex. Civ. App. 1977); _Simon v. Estate of Allen_, 497 S.W.2d 800 (Tex. Civ. App. 1973), _cert. denied_, 419 U.S. 843, 95 S.Ct. 76, 41 L.Ed.2d 71 (1974). The trustee has failed to show that either of these factors exist.

One indication of fraud and bad faith on the part of the controlling shareholder is corporate capitalization that is very small in relation to the nature of the corporation's business and to the risks that the business necessarily entails. _Arnold v. Phillips (In re Southern Brewing Co.)_, 117 F.2d 497 (5th Cir.), _cert. denied_, 313 U.S. 583, 61 S.Ct. 1102, 85 L.Ed.2d 1539 (1941). For fraud and bad faith to be

found, however, the inadequate capitalization must exist at the time of incorporation. Moore & Moore Drilling Co. v. White, 345 S.W.2d 559 (Tex. Civ. App. 1961). Such was clearly not true in this case. Although Fulghum Construction Company was acutely underfinanced at all times after Ranier & Associates purchased its stock in 1977, it was not so at the time of its inception.

Additionally, the Texas courts have set forth a number of factors to determine whether the requisite degree of shareholder control exists to warrant piercing the corporate veil. These include:

(1) commencement of business without the issuance of shares;

(2) a lack of shareholder or directors' meetings or of the signing of consents;

(3) the making of decision by shareholders as if they were partners;

(4) a failure to distinguish between corporate property and personal property;

(5) the use of corporate funds to pay personal expenses without proper accounting; and

(6) a failure to maintain complete and separate corporate and financial records.

Roylex, Inc. v. Langson Bros. Construction Co., 585 S.W.2d 768, 772 (Tex. Civ. App. 1979). None of these factors are applicable in this case. Moreover, as the Bankruptcy Court correctly stated:

> Evidence of informality or a commingling of shareholder and corporate affairs [such as occurred here], however, alone is insufficient to justify disregarding the corporate entity in the absence of bad faith on the part of the controlling shareholder or prejudice to third parties. . . . There must be a showing that the individual who controls the corporation and manages its business affairs does so in such a manner that individual or corporate creditors may be deprived of their legal rights by a shuffling of the legal personalities of the corporation and its controller to the extent that the corporation is, in fact, the alter ego of the controller or that the corporate formalities were not adhered to by the corporation in connection with the matters in question. William B. Roberts, Inc. v. McDrilling Co., 579 S.W.2d 335 (Tex. Civ. App. 1979).

No. 380-00235 at 12. Although Ranier & Associates and Fulghum Construction Company might not at all times have kept the ideal degree of separation

between themselves, it cannot be said that the shareholder so dominated the company or that the company's creditors were so prejudiced to justify disregarding the corporate entity. This Court agrees with the Bankruptcy Court that

> [a]ll of the proof indicates that all of the funds advanced to Fulghum in whatever form during 1978 and 1979 were intended to rehabilitate the company and to keep it solvent. . . .The actions taken by Ranier & Asscoiates after their purchase of Fulghum in 1977--the termination of the company's old mangement and the hiring of a new executive vice-president, the exercise by Nolan of complete control over the company's financial affairs, the transfer of the company's bank accounts to the Mt. Sterling bank, and the advances by Ranier & Associates during 1979 to meet Fulghum's payroll--are more indicative of an intent on the part of Ranier & Associates to rehabilitate the company than an intent by the shareholder to use the corporate shell for its own purposes.

No. 380-00235 at 14. As the Bankruptcy Court also correctly noted, simply having a unity of financial interest between the shareholder and company does not warrant piercing the veil, nor does the fact that the shareholder puts money into the corporation. Angus v. Air Coils, Inc., 567 S.W.2d 931 (Tex. Civ. App. 1978). There must also be some indication of bad faith or fraud on the part of the controlling shareholder. Even utilizing the "holistic" approach urged by the trustee and considering all the facts together, this Court must conclude that the trustee has not shown that such bad faith or fraud exists. See Cupples Coiled Pipe, Inc. v. Esco Supply Co., 591 S.W.2d 615 (Tex. Civ. App. 1979).

The conclusion of the Bankruptcy Court is thus affirmed.

The Net-Result Rule

The trustee also seeks to have this Court overturn the ruling of the Bankruptcy Court with regard to the series of financial transactions that occurred between the debtor and the shareholder during the months of June through November 1979. Because these transactions left the debtor in debt to the shareholder in the amount of $387,844.16, the Bankruptcy Court ruled that the payments made by the debtor to the shareholder did not constitute preferential transfers under section 547(b) of the Bankruptcy Code and were therefore not voidable by the trustee.

The trustee argues that this finding is erroneous and that all of the payments made by the debtor are preferences within the meaning of section 547(b) and therefore fully voidable by the trustee. The trustee also argues that even if the shareholder is allowed to set off against these preferences the advances that it made to the debtor, certain of the debtor's payments, totalling approximately $394,400, are still nonetheless voidable and recoverable by the trustee. This Court agrees with the Bankruptcy Court that the payments were not preferences within the meaning of section 547(b) and are therefore not voidable by the trustee.

At the heart of this dispute is the applicability of the so-called "net result" rule to the facts of this case. The central issue is whether the net result rule is operative under section 547(b) in the determination of whether a preferential transfer has actually been made or whether the rule exists only under section 547(c)(4) and applies only after a preference has already been determined to exist to enable a creditor to balance out certain transactions with the debtor.

Section 547(b) of the Bankruptcy Code sets forth the components of a preference. That section states:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor--

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made--

(A) on or within 90 days before the date of the filing of the petition, or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer--

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such credit would receive if--

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

The Bankruptcy Court found as fact that the shareholder was a creditor of the debtor, that the payments made by the debtor to the shareholder were for or on account of an antecedent debt, that the debtor was insolvent at the time the payments were made, and that the shareholder--an "insider"--knew that the debtor was insolvent. Because these findings are not clearly erroneous, they are accepted by this Court. *See* Rule 810, Rules of Bankruptcy Procedure. Thus, the payments by the debtor clearly satisfy the requirements of subsections (1)-(4) of

section 547. The dispute in this case, then, is over whether the payments also satisfy the final requirement of section 547(b)(5), which states in relevant part that to be a preference a payment must "enable . . . such creditor to receive more than such creditor would receive if . . . the transfer had not been made. . . ."

As the Bankruptcy Court stated, the test for determining whether the requirement of section 547(b)(5) has been met is "whether the creditor obtained from the debtor's property a greater percentage of his debt than some other creditor would have received under the distributive provisions of the Code had the transfer not occurred." 7 B.R. at 639. 4 Collier,

Bankruptcy ¶ 547.35 (15th ed. 1980).

The Bankruptcy Code also stated that

> [w]hether a creditor has received a preference under the [Bankruptcy] Act was determined not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results.

Id. In applying the above-stated test, then, the Bankrupcy Court employed a "net result" approach. Under this approach the Bankruptcy Court examined whether the net effect of all the transactions between the debtor and the shareholder was actually to deplete the debtor's estate and thereby interfere with an equal distribution of the debtor's assets among creditors or whether

the net effect was to increase the debtor's estate and thereby benefit all the creditors. Because the net result of the transactions was to increase the debtor's estate, in that the shareholder advanced $387,844.16 more than it received in return, the Bankruptcy Court ruled that the section 547(b)(5) requirement had not been met. The Bankruptcy Court thus held that the payments were not voidable transfers under section 547(b).

In appealing the Bankruptcy Court's decision to this Court, the trustee argues that the Bankruptcy Court misapplied--and misunderstood--the net result rule. The trustee argues that the net result rule has nothing whatsoever to do with

section 547(b). Instead, the trustee argues, the net result rule is a defense of sorts that a creditor may raise under section 547(c)(4) only <u>after</u> a preferential transfer has been found to have been made under section 547(b). Under the trustee's interpretation, then, the net result rule does not preclude the existence of a preference, but rather, only immunizes certain preferential payments from avoidance by the trustee, provided the transfers meet the specifications of section 547(c)(4). The trustee criticizes the Bankruptcy Court for, in his words, "injecting" the net result rule into section 547(b)(5).

The trustee has offered a number of arguments in support of his

position, but this Court concludes that it must respectfully reject them all. Rather than there being only one net result rule--embodied in section 547(c)(4) as the trustee urges--this Court must agree with the Bankruptcy Court that two "net result rules" actually exist in bankruptcy law. One, that of section 547(c)(4) and insisted upon by the trustee, is statutory. The other, that applied by the Bankruptcy Court, is nonstatutory, a judicial gloss upon the requirements of section 547(b).

The Bankruptcy Court's thorough review of the relevant case law indicates clearly that over the years the courts have utilized a net result approach under section 60(a) of the old

Bankruptcy Act, the predecessor to section 547(b), as well as under section 60(c) of the Act, the predecessor to section 547(c)(4). See Joseph Wild & Co. v. Provident Life & Trust Co., 214 U.S. 292, 29 S.Ct. 619, 53 L.Ed. 1003 (1909); Yaple v. Dahl-Millikan Grocery Co., 193 U.S. 526, 24 S.Ct. 552, 48 L.Ed. 776 (1904); Jaquith v. Alden, 189 U.S. 78, 23 S.Ct. 649, 47 L.Ed. 717 (1903); Federal International Banking Co. v. Childs (In re Fred Stern & Co.), 54 F.2d 478 (2d Cir. 1931); Mills v. J.H. Fisher & Co., 159 F. 897 (6th Cir. 1908). See also In re Sagor & Brother, 9 Am Bkrtcy. Rptr. 361 (2d Cir. 1903); Gans v. Ellison, 114 F. 734 (3rd Cir. 1902); Kimball v. E.A. Rosenham Co.,

114 F. 85 (8th Cir. 1902); Dickson v. Wyman, 111 F. 726 (1st Cir. 1901). Commentary on the old Act also confirms use of the net result rule under section 60(a):

> The net result rule developed in the days when preferences were voidable even though there was no knowledge or reasonable cause to believe insolvency of the debtor. It provided that if there is a running account of credit and payment, the entire transactions over the 4 months are examined and if more credits than payments occurred, even though individual payments during the period might comprise a preference, there is no preference. That is, if the net result enriches the estate there is no preference. Indications are that the rule would apply partially. That is, a transfer was only preferential to the extent that transfers exceeded creditors to the debtor.

2 Cowans, Bankruptcy Law and Practice § 474 (2d ed. 1978) (citations omitted).

The rationale for application of the net result rule to the determination of preferences under section 60(a) was stated cogently by the Second Circuit in Federal International Banking Co. v. Childs (In re Fred Stern & Co.), 54 F.2d 478 (2d Cir. 1931):

> It is unjust to hold that, because the appellee has in the ordinary course of business during the four months preceding bankruptcy received payments which, under similar circumstances, might operate as a preference in some views of the law, it will bar the proof of this claim when, looking at all the transactions together, they demonstrate they were without any intention to acquire or to give any unjust preferences, and particularly where they have increased the net indebtedness to the creditor and effected a corresponding increase of the bankrupt's estate. . . .In order to avoid such an unreasonable result, it is proper to hold that all the transactions covered by this account will be regarded as one, so that it may not be held

> that the effect of any of the payments was to enable the appellee to obtain a greater percentage of its debt than any other creditor of the same class, within the meaning of the Bankruptcy Act. . . . The test in determining the absence or existence of a preference is whether or not the entire course of dealings on the open account, resulting from this revolving credit, resulted in the enrichment of the insolvent estate.

54 F.2d at 480. Clearly, in the case before this Court, the overall result of the transactions between the debtor and the shareholder was to enrich the estate of the debtor by nearly $400,000. To adopt the position urged by the trustee that the debtor's payments to the creditor were preferences potentially voidable by the trustee would be to bring about exactly the sort of "unjust" and "unreasonable"

result opposed by Sterns and the other decisions cited above. This Court thus agrees with the Bankruptcy Court that the net result rule has not been limited to section 60(c). The net result rule is properly applicable under section 60(a)--now section 547(b)(5)--and seems well suited to use in this particular case.

Before this Court can say conclusively, however, that the payments made by the debtor to the shareholder in this case are not preferences, one other issue must be addressed: whether the shareholder's knowledge of the debtor's insolvency precludes application of the net result rule in this particular case. This Court agrees with the Bankruptcy Court that it does not.

The trustee argues that the decisions of those courts applying the net result rule in any respect have predicated their conclusions on the creditor's ignorance of the debtor's bankrupt status. In other words, the trustee argues that any knowledge by a creditor of a debtor's precarious financial situation prevents application of the net result rule to the transactions between them. In support of his contention, the trustee relies upon several decisions that have in fact stated that the net result rule in inapplicable under such circumstances. _See_ _Cooper Petroleum Co. v. Hart_, 379 F.2d 777 (5th Cir. 1967); _Campanella v. Liebowitz (In re Peter Cassinelli Macaroni Co.)_, 103 F.2d 252 (3d Cir.

1939); <u>In re Grocers' Baking Co.</u>, 266 F. 900 (M.D. & N.D. Ala. 1920), <u>aff'd sub nom</u>. <u>Eagleston v. Birmingham Trust & Savings Co.</u>, 277 F. 1015 (5th Cir. 1921); <u>In re Farmer's Store & Supply Co.</u>, 214 F. 505 (N.D. Wa. 1914). The trustee relies in particular on <u>Cooper Petroleum Co. v. Hart</u>, 379 F.2d 777 (5th Cir. 1967), in which the Fifth Circuit ruled that the net result rule was inapplicable when a creditor knows or has sufficient reason to know that the debtor is insolvent at the time the transactions take place. The Fifth Circuit based its decision to a great extent on its conclusion that

> the Supreme Court decisions in which the rule arose as well as subsequent cases relying upon those decisions appear to have placed much more emphasis upon the

> creditor's lack of knowledge of the debtor's insolvency to justify application of the rule than upon any rationalization as to enrichment of the debtor's estate.

379 F.2d at 780.

While the cases cited by the trustee are strong support for his position, there are, as the Bankruptcy Court noted, several decisions in which a creditor's knowledge of the debtor's insolvency did not affect application of the net result rule. See Farmers Bank v. Julian, 383 F.2d 314 (8th Cir.), cert. denied, 389 U.S. 1021, 88 S.Ct. 593, 9 L.Ed.2d 662 (1967); Wilson v. Kanter (In re Marley-Morse Co.), 275 F. 832 (7th Cir. 1921); In re Stewart, 233 F. Supp. 89 (D. Or. 1964). The thrust of these decisions is not only that the enrichment of the debtor's

estate is far more important than the creditor's knowledge of the debtor's financial status in determining the applicability of the rule, but also that strong policy considerations make the creditor's knowledge irrelevant. As the court in In re Stewart declared, to deny application of the net result rule simply because the creditor is aware of the debtor's condition

> would create chaos in that vast area of business relationships where the creditor has knowledge of the debtor's difficulty, but desires to assist in solving the problems by going along with the debtor on an arrangement similar to [the one presented here]. . . . [A] plan such as that, time after time, assists the debtor in putting his house in order, paying all creditors and making a success of his own venture. To treat such a transaction as a preference within the meaning of the bankruptcy act would be nothing short of placing a premium, or a brand

> of approval, on the actions of those creditors who do not attempt to assist the debtor, but on the other hand attach the property and thus force the debtor out of business.

233 F. Supp. at 92.

The Bankruptcy Court was persuaded by the force and logic of these latter decisions and ruled that the shareholder's knowledge of the debtor's insolvency in this case did not preclude applying the net result rule here. This Court believes that the Bankruptcy Court's conclusion is correct. Having reviewed the Supreme Court's decision in Joseph Wild, Yaple, and Jaquith, this Court does not agree with the conclusion of the Fifth Circuit in Cooper Petroleum or the position of the trustee in this case that those

decisions depended on the knowledge, or lack thereof, of the creditor. In fact, from a close reading of the three decisions, it is difficult to discern any support in the opinions for the proposition that the creditor's knowledge was in any way determinative of the results reached by the Court. Although the creditor's lack of knowledge of the debtor's insolvency was posed by counsel as one component of one question for review in Yaple, the Court summarily applied the net result rule to the facts of that case and in no way indicated that the issue of knowledge was influential in its decision. 193 U.S. at 517, 24 S.Ct. at 553, 48 L.Ed. at 776. Indeed, in Joseph Wild, the Court declared that Yaple stood for the specific principal that

> where a creditor has a claim upon an open account for goods sold and delivered during the period of four months before the adjudication in bankruptcy, the account being made up of debits and credits, leaving a net amount due from the bankrupt estate, . . .payments made under such circumstances [do] not constitute preferences. . . .

214 U.S. at 297, 29 S.Ct. at 619, 53 L.Ed. at 1004. No mention is made of the creditor's knowledge or lack of knowledge.

As is apparent, disagreement exists among the courts regarding the question of a creditor's knowledge of insolvency. In the absence of any clear weight of authority on either side of this issue, this Court believes

that the better rule of law is that a creditor's knowledge does not preclude application of the net result rule to determine the existence or nonexistence of preferential transfers under section 547(b) of the Bankruptcy Code. In addition to agreeing with the extremely persuasive policy argument articulated by the court in In re Stewart, this Court concurs with the position of the Bankruptcy Court that requiring ignorance of insolvency would be inconsistent not only with the requirements of section 60(a), as it existed, but also with the requirements of the present section 547(b) with regard to both insiders and others. See 7 B.R. at 647. Moreover, this Court agrees with the Bankruptcy Court that such a knowledge factor

> would be inconsistent with the fundamental purpose for the voidable preference provisions of the Code, which is not the imposition of a penalty upon creditors preferred by the debtor, but the equitable distribution of the debtor's assets among all creditors.

Id. Application of the net result rule to the present case ensures that the goal of equitable distribution will be met.

As a final point with regard to this issue, the trustee argues that even if the net result rule is applicable, the shareholder must have made each advance after a payment by the debtor in order to escape avoidance. Under this argument, the shareholder would be entitled to set off $837,000 of the advances made by it to the debtor, while being required to return

approximately $394,400 in payments. This latter sum is the amount that the trustee alleges that payments by the debtor exceeded subsequent advances by the shareholder after July 27, 1979. The Court respectfully rejects this argument. Even if the transactions between the shareholder and the debtor could be dichotomized by the July 27 date--a notion upon which this Court declines to comment--the trustee's argument is irrelevant because it is based upon a reading of the set-off provision of section 547(c)(4). See 2 Cowans, Bankruptcy Law and Practice § 474 (2d ed. 1978). Since section 547(c) is never called into play unless a preference is found to exist and since this Court agrees with the

Bankruptcy Court that the payments made by the debtor here were not preferences, the trustee's argument must fail as moot. This Court offers no opinion about the validity of the argument in a case in which preferential transfers are found to exist.

For all of the foregoing reasons, this Court agrees with the Bankruptcy Court that the payments here in question were not to any extent preferences under section 547 of the Bankruptcy Code. The conclusion of the Bankruptcy Court is affirmed.

Ranier & Associates' Counterclaim

The last issue to be resolved in this case is the counterclaim by Ranier & Associates against the trustee for

damages allegedly incurred because of the trustee's detention of the above-discussed equipment during the initial stages of the bankruptcy procedure. Although Ranier & Associates asserts that it suffered $354,764 in damages, which sum it alleges it could have acquired by renting out the equipment, the Bankruptcy Court found that Ranier & Associates offered no proof that such damage actually was suffered. This Court agrees with the Bankruptcy Court that no proof of any damage suffered by Ranier & Assocaites because of the trustee's actions exists in the record. Accordingly, this Court concludes that the Bankruptcy Court acted correctly in dismissing the counterclaim.

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE MIDDLE DISTRICT OF TENNESSEE

IN RE:

FULGHUM CONSTRUCTION
COMPANY,

Debtor CASE NO. 380-00235

ROBERT H. WALDSCHMIDT
TRUSTEE,

Plaintiff
VS. ADV. PROC. NO. 380-0081

HARRY H. RANIER,
ALGIN H. NOLAN,
RANIER & ASSOCIATES,
EGAN IRON WORKS,
FIRST SECURITY NATIONAL
BANK OF LEXINGTON,
and
LIBERTY NATIONAL LEASING
COMPANY,

Defendants

JUDGMENT

In accordance with the Memoranda entered herein on July 14, 1980, and contemporaneously herewith,

It is ORDERED, ADJUDGED AND DECREED that the complaint of the plaintiff trustee is dismissed; and

It is further ORDERED, ADJUDGED AND DECREED that the equipment which is the subject of the counter-claim of the defendant, Ranier & Associates, Inc., having finally been sold which is precisely what the plaintiff trustee requested in his complaint and said defendant having offered no proof of any damages suffered having offered no proof of plaintiff trustee's allegedly groundless assertion of ownership interest in said equipment, the counter-claim of said defendant is hereby dismissed.

Dated this 28th day of November

980.

/s/ Russell H. Hippe, Jr.
RUSSELL H. HIPPE, JR.
Bankruptcy Judge

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BANK OF LEXINGTON,
and
LIBERTY NATIONAL LEASING
COMPANY,

Defendants

MEMORANDUM

APPEARANCES:

For the Plaintiff

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RUSSELL H. HIPPE, JR.
BANKRUPTCY JUDGE

In this adversary proceeding involving numerous substantial transactions between the debtor corporation and its sole shareholder, Ranier & Associates, a partnership composed of Harry H. Ranier and Algin H. Nolan, general partners, the court has previously entered a partial judgment disposing of the rights of the trustee and the defendants in certain equipment that had been sold by he debtor to the shareholder. Waldschmidt v. Ranier, Bk Adv. Proc. No. 380-0081 (Bankr. Ct. M.D. Tenn., July 14, 1980).[1] As noted in paragraph 13 of the memorandum entered on July 14, 1980, there were almost one hundred transactions between the shareholder and the debtor during the period June 1978 through November

1979, when the debtor ceased doing business. As a result of the shareholder's purchase of the equipment, the shareholder became indebted to the debtor for a period of time. On June 5, 1979, however, an advance made to the debtor by the shareholder rendered its aggregate advances in excess of its obligations to the debtor, and thereafter the debtor was indebted to the shareholder in varying amounts. At present the debtor owes the shareholder the sum of $387,844.16. Most of the advances made by the shareholder subsequent to June 5, 1979, were in the form of deposits made to cover the debtor's payroll to ensure completion of jobs in progress. Generally, payments that the debtor received from these jobs were

applied to the indebtedness to the shareholder. In entering the partial judgment in July, the court continued under advisement the issue of whether payments made by the debtor subsequent to June 5, 1979, constituted voidable preferences under § 547(b) of the Bankruptcy Reform Act of 1878. All of the payments were made within one year prior to the filing of the involuntary petition on January 25, 1980.

The shareholder does not dispute that these payments made were transfers of the debtor's property as required by § 547(b). The shareholder asserts that it was not a creditor of the debtor, that the transfers were not in payment of antecedent debts owed to it, that the debtor was not insolvent at the

time of the transfers, that the shareholder had no reasonable cause to believe that the debtor was insolvent at the time of the transfers, and that, even if the transfers are characterized as voidable preferences, they come within the exceptions provided by § 547(c)(1), (2), (4).

Transfer to or for the Benefit of a Creditor under § 547(b)(1)

The Bankruptcy Reform Act of 1978 [hereinafter referred to as the Code to distinguish it from the prior Bankruptcy Act of 1898] includes in its definition of "creditor" an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(9)(A). The Code defines "claim" as a

> right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured . . . .

11 U.S.C. § 101(4)(A). The legislative history of § 101(4) indicates that the drafters intended by it to provide the "broadest possible definition":

> the bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case.

S. REP. NO. 95-989, 95th Cong., 2d Sess. 22 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 309 (1977).

It is readily apparent that the shareholder was a creditor of the debtor's for the purpose of § 547(b).

Antecedent Debt under § 547(b)(2)

The Code defines "debt" as a "liability on a claim." 11 U.S.C. § 101(11). The legislative history of § 101(11) indicates that the terms "debt" and "claim" are coextensive and that the debtor owes a debt to the creditor to the extent that the creditor has a claim against the debtor. S. REP. NO. 95-989, 95th Cong., 2d Sess. 23 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 310 (1977).

At all times subsequent to June 5, 1979, the debtor was indebted to the shareholder. Thus each of the transfers from the debtor to the shareholder was "for or on account of an antecedent debt owed by the debtor before such transfer was made."

Insolvency of the Debtor under § 547(b)(3)

Section 547(b)(3) requires a showing that, at the time of the transfer that is sought to be avoided, the debtor was insolvent. Although section 547(f) provides a presumption of insolvency during the 90 days prior to filing, the trustee still has the ultimate burden of persuasion, the presumption merely requiring that the party against whom it exists to come forward with some evidence to rebut it. S. REP. NO. 95-989, 95th Cong., 2d Sess. 89 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 375 (1977); 4 COLLIER, BANKRUPTCY ¶ 547.26 (15th ed. 1980).

Section 101(26)(A) defines "insolvent" with reference to an entity other than a partnership as

> financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of--
>
> (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
>
> (ii) property that may be exempted from property of the estate under section 522 of this title; . . . .

The Code thus retains the balance-sheet test of insolvency of the prior Bankruptcy Act of 1898, as amended, [hereinafter referred to as the Act to distinguish it from the Bankruptcy Reform Act]. S. REP. NO. 95-989, 95th Cong., 2d Sess. 25 (1978);

H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 312 (1977); 4 COLLIER, BANKRUPTCY ¶ 547.26.

The party seeking to avoid a preference thus must establish the fair valuation of all of the debtor's assets at the time of the transfer. See Levit, The Archaic Concept of Balance Sheet Insolvency, 47 AM. BANKR. L.J. 215, 219 (1973). The cases under the prior Act established that "fair valuation" signified the reasonable estimate of what could be realized from the assets by converting them into, or reducing them to, cash under carefully guarded, if not ideal, conditions. Hunter Press, Inc. v. Connecticut Bank & Trust Co., 420 F. Supp. 338, 341 (D. Conn. 1976); In re Alexandria Sand and

Gravel Co., 17 C.B.C. 11, 16 (S.D. Ohio 1978) (B.J.); 1 COLLIER, BANKRUPTCY ¶1.19[3] (14th ed. 1974). Fair valuation was held by the courts not to be synonymous with a distressed or forced sale price. Hunter Press, Inc. v. Connecticut Bank & Trust Co., 420 F. Supp. 338, 341 (D. Conn. 1976); Darby v. Shawnee Southwest, Inc., 399 F. Supp. 587, 591 (W.D. Okla. 1975). The proper standard applied under the former Act was that enunciated in Syracuse Engineering Co. v. Haight, 110 F.2d 468, 471 (2d Cir. 1940):

> Fair valuation of an estate such as this might conceivably be based on forced sale prices, or on fair market prices, or on so-called intrinsic values, irrespective of sale. A proper regard for the interests of the bankrupt, as well as for the interests of his creditors, compels the conclusion that fair market price is the most

equitable standard. Bonbright and Pickett, Valuation to Determine Solvency under the Bankruptcy Act, 29 Col.L.Rev. 582, 597, 598; 1 Collier on Bankruptcy (14th Ed. 1940) 74-81, collecting cases. It involves a value that can be made available for payment of debts within a reasonable period of time. In re United Finance Corp., supra [104 F.2d 593 (7th Cir. 1939)]; Rabbitt v. Read, 2 Cir., 236 F. 42, 47, certiorari denied 243 U.S. 648, 37 S.Ct. 475, 61 L.Ed. 946; Stern v. Paper, D.C.N.D., 183 F. 228, 230, 231, affirmed 8 Cir., 198 F. 642. And fair market value implies not only a "willing buyer," but a "willing seller." Grandison v. National Bank of Commerce, 2 Cir., 231 F. 800, 804, certiorari denied 242 U.S. 644, 37 S.Ct. 213, 61 L.Ed. 542; Irvin Trust Co. v. Manufacturers' Trust Co., D.C.S.D.N.Y., 6 F.Supp. 185; Collier, supra at 77.

The fair value of the debtor's property may be established from balance sheets, financial statements, appraisals, expert testimony, and other affirmative evidence. Edmondson v.

Caldwell (In re Phippens), 4 Bankr. Rep. 155, 159 (Bankr. Ct. M.D. Tenn. 1980). Reduction in the face value of the debtor's assets may be appropriate if those assets are not susceptible to liquidation and thus cannot be made available for the payment of debts within a reasonable time. Constructora Maza, Inc. v. Banco de Ponce, 616 F.2d 573 (1st Cir. 1980).

The legislative history of § 547 does not reveal any intention on the part of the Congress to change the state of the law relating to proof of insolvency that was in effect under the former Act.

The trustee's proof consisted of a series of corporate balance sheets; the testimony of Nolan, a certified public

accountant who was one of the shareholder's two general partners; the testimony of the debtor's former president; and that of its former secretary-treasurer, James Gray. The shareholder's proof consisted principally of the testimony by Charles Linden, a certified public accountant who had prepared certain of the debtor's balance sheets.

The corporate balance sheet for the month ending September 30, 1979, indicates that the debtor's liabilities exceeded its assets by more than $230,000. The corporate balance sheet for the previous month was not introduced. The balance sheets for the months ending June 30, 1979, and July 31, 1979, indicate that the debtor's

assets exceeded its liabilities. Among the assets included in these two balance sheets are amounts for "equity in jobs." The trustee asserts that the amounts for "equity in jobs" should be disregarded in determining whether the debtor was solvent and that, as a result, the court should find that the debtor was insolvent during June 1979, when the shareholder's status shifted from that of a debtor to that of a creditor of the debtor's.

The debtor used the completed-contract method of accounting, as opposed to the percentage-of-completion method. The completed-contract method recognizes income only on completion or substantial completion of long-term construction contracts, while

the percentage-of-completion method recognizes revenues when the earning process is complete or virtually complete and an exchange has taken place. M. MILLER, GENERALLY ACCEPTED ACCOUNTING PRINCIPLES GUIDE 27.01-27.02 (1979). In accounting for long-term construction contracts under the completed-contract method,

> excess of accumulated costs over related billings should be reflected in the balance sheet as a current asset, and excess of accumulated billings over related costs should usually be reflected as a current liability. In the case of more than one contract, the accumulated costs or liabilities should be separately stated on the balance sheet. The preferred terminology for the balance sheet presentation should be "(Costs) (Billings) of uncompleted contracts in excess of related (billings) (costs)."

Id. at 27.01. At interim balance-sheet

dates the excess of either the overhead and direct costs or the credit billing and/or cash received over the other is classified as a current asset or a current liability, because of the normal operating cycle concept. Id. at 27.02. The interim-balance-sheet treatment of long-term contracts under the completed-contract method is the same as that under the percentage-of-completion method, except that under the latter, the amount of estimated gross profit earned in each period is recorded by charging a construction-in-progress account and crediting realized gross profit. Id. at 27.03.

The debtor's secretary-treasurer, Gray, prepared all of the data that

appear on the balance sheets and forwarded the information to Nolan. Nolan reviewed the information and forwarded it to the computer center, which printed out the balance sheets. Exhibit L (Nolan Deposition) 33. When asked to explain the term "equity in jobs" as it appears on the balance sheets, Gray responded:

> A. Well, to me, it would be the amount of money that we invested in the particular job that was in progress at that time.
>
> Q. So it was money which was actually invested into a job, not money which the corporation had. Is that correct?
>
> A. That's right.
>
> Q. And in order for the corporation to get any asset or any value out of that particular asset, it would have to complete the job in the future. Is that correct?
>
> A. Yes, sir. Mm-hmm.

Q. If the company were to stop at any one point in time, according to that sheet, according to that financial statement, is there any way that the company could realize the amount of money stated in that figure of equity in the job?

A. Not according to this statement here, no.

. . . .

Q. Would this figure of equity in jobs be expected funds to be received in the future, expected income, expected profit from future operations of the business?

A. Well, it would --. No, not exactly because the job--you could have equity in the job, and still the job might end up as a profit or a loss. This would, to me, it would tell you that you had this much money invested in this job at that particular time. And that has no relationship to the final outcome of the job as far as profit is concerned.

1 Trial Transcript 91-92. In response to a similar inquiry during his deposition on April 9, Nolan testified:

A. . . . The equity in jobs arise from matching the amount of cash that has been received from a particular job against the amount that has been spent on that particular job.

Q. Now, explain that again. Would that be actual assets money in the bank or --

A. No.

Q. That would be expected profit from a particular job?

A. No. All this is, is Mr. Gray had schedules, which are in the financial statements that I am showing you here, showing how much had been spent on a particular job and how much cash that he had received against that particular job. And that's all this is. It doesn't have anything to do with whether there is going to be a profit or a loss.

In this particular instance, since it is a debit and not a credit, if all of the jobs were terminated and all of the money was in, this would reflect a loss of five sixty-nine.

Q. So, you did not actually have that asset at the time the statement was prepared? It was more or

less just a figure which was put in there to reflect at what stage a particular job in progress was?

A. That's right. Just a matching process of the expenses spent to date and the cash received to date. Not the income, but the cash received. And it didn't reflect, really, whether there was a profit or a loss in the job.

Q. So, if the corporation were halted on June 30 of 1979 and all of the assets sold, that figure, equity in jobs, would probably not be an asset of the company?

A. At that particular time, if all of the cash had been received and all of the expenses had been paid and there was five hundred sixty-nine thousand dollars difference between that that was spent and that that was paid, then that would be a loss. Yes. If it happened to be that the cash was more, then it would be a profit. Now, this is a total of all of the jobs that were in process at that time. It is broken down job by job.

Q. Okay. What I am trying to determine is that if you were to liquidate the company on June 30 of 1979, the figure for equity in jobs, that would not be an asset,

as such? I mean, you would not be able to reduce that to --

A. In order to determine it, you would have to record your income, you know, your amount that you had received or that you were going to receive, and then when you finally got that matching process done, that's correct, whatever that happened to be would reflect whether it was a profit or a loss.

Q. It would reflect whether it was a profit or loss, but as to whether it is an asset at the present time, it would not be a liquidable asset as of June 30 of 1979?

A. It would just reflect the amount that was spent in excess of the amount of income that they had received.

Q. So, the figure in the assets column, it is not an asset you could lay your hands on or an asset you could go to the bank and take out or an asset you could sell, it was more or less an asset which is just a bookkeeping figure?

A. Yeah, it was not -- You wouldn't be able to determine from this, the way this internal statement was, whether that was going

to be a profit or a loss. So, therefore, if you went to a bank and said, I have work in process of five hundred sixty-nine thousand, they would say, well, how much money are you going to receive in connection with that work in process. And if you could show them that you were going to receive a million five hundred sixty-nine thousand, then that would be a good thing. But if you were only going to receive a hundred thousand dollars, then they would know that four hundred sixty-nine thousand would be a loss.

Q. So, this equity in jobs could also be labeled work in progress or expected receipts from continued operation or continuation of a job?

A. Hopefully, it would be expected receipts if it was going to be a profit.

Exhibit L (Nolan Deposition) 34-37.

Linden, the certified public accountant who was called as a witness for the defendants, described "equity in jobs" as

normally the cost you've accumulated, which includes a direct job cost, overhead cost, an allocation of overhead costs -- and this could be uncompleted jobs -- in excess of the billings on those jobs.

5 Trial Transcript 18. At the conclusion of the cross-examination of the certified public accountant, the court initiated with the witness the colloquy that follows:

THE COURT: Let me understand about the equity in jobs. If you only had one job and you had allocated to the equity-in-jobs account whatever is the corporate amount of overhead -- I guess you had one job that you allocated all of your overhead?

THE WITNESS: Well, there'd be certain things maybe, like our secretarial cost or something like that.

THE COURT: Then you'd allocate all the direct costs that you had, then, on a particular job?

THE WITNESS: Yes.

THE COURT: And then you would take from that whatever payments had been made on the job; is that correct?

THE WITNESS: Yes, the billings, it's called. The terminology is billings to date.

THE COURT: So if you then had a figure, say, $100,000, where the cost had exceeded income that had "been received on the job, if you end up losing money on that job then that would not be an asset? That would be a zero --

THE WITNESS: When the job was ultimately closed, if you lose money, then it clears out and goes through your income statement, and then it would be a loss as it goes through the income statement.

THE COURT: So the fact that you have a hundred thousand dollar figure as equity in a job is really not meaningful until you actually complete the job?

THE WITNESS: Well, it is, because you have a contract sitting out there for a total amount. It's based on you have an X number of dollars for the contract, and then you have costs in that contract. So you have to relate the two together. Think of it as a

manufacturing company. They have work in process of inventory in process, and it's sitting there in their inventory until they complete it. Then they sell it, and they recognize a dollar for it, and they take it out of their inventory, and then it goes into cost of sales then.

THE COURT: To get back to the hundred thousand dollars, if you end up losing $20,000 of that job, that means that was an $80,000 asset; is that correct? You're carrying it at $100,000 at a particular point in time, and you finally work all the way through the contract.

THE WITNESS: Right.

THE COURT: And you've lost $20,000. That means, I assume, that your costs have exceeded the total revenue by $20,000?

THE WITNESS: Right.

THE COURT: When you had the [$]100,000, you had contemplated receiving [$]100,000 in revenue to offset those costs, which you never received?

THE WITNESS: Yes.

THE COURT: So that meant that that $100,000 asset would end up being an $80,000 asset? If you lost $100,000 on the job, then the [$]100,000 went to zero?

THE WITNESS: Well, I don't think the [$]100,000 goes down. The way you look at [it] is you have, say if the contract was [$]100,000 --

THE COURT: You had equity in the job at a particular point in time of $100,000.

THE WITNESS: Okay.

THE COURT: That's costs that you expect to recover from the payments on the job?

THE WITNESS: Right, okay.

THE COURT: And if you eventually don't get enough payments to cover all your costs, then that $100,000 plus at that point in time may end up being, say, if you lost $20,000 on the job, an $80,000 plus?

THE WITNESS: Right. All the accounts receivable that you don't collect, you lose it, that's right.

THE COURT: And if you lost $100,000 on the job, then the $100,000 goes to zero?

WITNESS: Yes.

5 Trial Transcript 26-29.

Nolan testified in the following manner concerning the liquidity of "equity in jobs":

> Q. If the company were liquidated as of the date of any one of these balance sheets, that equity in progress would not be a liquidable asset, isn't that correct?
>
> A. You can't tell from this financial statement whether that would be true or not. You don't have a full financial statement here. You have half of a financial statement. You only have a balance sheet.
>
> You have to have the income statement. You have to have the job cost schedules in order to see whether -- and also, you have to know whether there's going to be profit in that job or not. So you can't say, from looking at this financial statement, whether that would be an asset, or whether it would not be an asset. It appears to be an asset on this financial statement, but you can't --
>
> Q. You're saying you can't tell, but it's listed as an asset, isn't that correct?

A. It is listed as an asset. If it were accurate, sir, it would be an asset.

Q. Could, if I owned that asset that's listed there in that asset column and I had a sale here at the corner of Eighth and Broadway, could I sell that asset?

A. If you could go on and bill the customers that you had gotten the jobs from for additional income, then that would turn that over. And yes, sir, that would be an asset that you could sell.

Q. But you would have to be able to continue performing under the contract and finish the job for that asset to have any value?

. . . .

. . . for that asset to be able to be liquidated, you basically had to have funds to finish the job or would have to be able to finish the job, is that correct?

A. From looking at this financial statement, I can't say that's correct or not correct.

3 Trial Transcript 204-05.

Both Nolan and Linden testified that, at best, the "equity in jobs" figure was an estimate of the accumulated costs (direct job costs, overhead costs, and allocation-of-overhead costs) in excess of the billings to date on those jobs and that the figure did not represent the gain or loss resulting from the jobs. Linden testified that "you'd have to look at the jobs" to determine whether the figure accurately reflected an asset at any given point in time prior to completion of the job contracts. 5 Trial Transcript 25.

The debtor was without any jobs during 1978. Exhibit L (Nolan Deposition) 40-41. The debtor's only income for the year 1978 was from the periodic

rental of equipment. Id. The debtor's average monthly overhead during 1978 was $35,000. Id. at 40. Beginning in January 1979, the debtor's monthly overhead increased to $50,000. Id. at 41. In May or June of 1979 the debtor was awarded four job contracts. 3 Trial Transcript 219. To finance these contracts, the shareholder obtained a $400,000 loan from United American Bank in Knoxville, Tennessee, and an additional $200,000 loan from Liberty National Bank in Louisville, Kentucky, secured by a certificate of deposit owned by Ranier's mother. 3 Trial Transcript 221-23; Exhibit L (Nolan Deposition) 44, 46. The debtor itself was unable to obtain any financing because of its dismal earnings for the

prior year. 3 Trial Transcript 221. Even the financing that the shareholder obtained for the debtor soon proved insufficient to meet the debtor's job costs. Nolan testified that from the time the debtor was awarded the four contracts in May or June of 1979, the debtor was always "hurting for money." Exhibit L (Nolan Deposition) 46. It was this situation, in fact, that necessitated most of the transactions herein at issue. The shareholder deposited its own funds into the debtor's payroll account, for instance, to ensure completion of the jobs in progress. <u>See</u> 4 Trial Transcript 359-60. The shareholder also deposited its own funds into the debtor's general account to cover overdrafts for trade

payables. 4 Trial Transcript 363. Payments on the debtor's billings on the four jobs uniformly were delinquent, and, as a result, the debtor's bank accounts uniformly were in an overdraft status. Each of the four job contracts resulted in a loss to the debtor. The posting of invoices in November of 1979 that increased the debtor's accounts payable by approximately $605,000 was not the first indication that a loss would be sustained, but rather only demonstrated, according to Nolan, that the loss was to be much larger than had been anticipated. 3 Trial Transcript 225; Exhibit L (Nolan Deposition) 47-49.

The facts before the court in this proceeding are similar to those before

the First Circuit Court of Appeals in Constructora Maza, Inc. v. Banco de Ponce, 616 F.2d 573 (1st Cir. 1980). In Constructora Maza, the debtor in possession was engaged in the construction of single- and multi-unit residential structures. To secure certain of its indebtedness, the debtor in possession within four months of its filing had assigned to a bank all of the retainages and progress billings due on its outstanding construction projects, certificates of deposit, and certain promissory notes that it held as obligee. In determining whether the debtor in possession was insolvent at the time of these transfers for the purpose of § 60(b) of the old Act, both the trial court and the appellate court

considered a financial statement that the debtor in possession had prepared using the percentage-of-completion method of accounting. The financial statement purported to show the debtor's financial condition as of June 30, 1975, and included as an asset an entry for retainages on outstanding construction contracts. The debtor in possession's former executive vice-president testified that nearly the entire figure represented progress billings that were uncollectible due to defects in construction, a lack of funds with which to complete the project, and the debtor's inability to obtain any new contracts in the nine months subsequent to the preparation of the financial statement. The trial

court refused to consider these sums as assets in the preference context and concluded from the resulting deficit in liabilities over assets that the debtor had been insolvent at the time of the transfers. The First Circuit affirmed. 616 F.2d at 573, 577-78.

"Equity in jobs" as a term referring merely to a corporation's investment in uncompleted jobs is meaningless. "Equity in jobs" as a term referring to accrued profit (earnings less costs) that has not yet been collected would properly be classified as an asset for balance-sheet purposes, especially if the debtor could show that parallel figures for actual costs were less than or equal to figures for projected costs. In a bankruptcy

proceeding to determine whether preferential transfers have been made, however, the court must assess the value of a debtor's "equity in jobs" not strictly in accounting terms, but in terms of the fair market price that a willing purchaser would have offered for the same at the time that the alleged preference occurred. In this proceeding, the court is of the view that the attitude of such a purchaser would have been analogous to that taken by the banks and other institutions that declined to advance funds directly to the debtor during the summer of 1979. The court finds that, based upon the facts reviewed above, such a purchaser not only would have been unwilling to offer a price equal to the

figure that appears on the balance sheet at the end of June 1979, but would have been unwilling to offer any price at all. From the resulting deficit in liabilities over the debtor's assets for the period ending June 30, 1979, the court concludes that the debtor in possession was insolvent for the purpose of § 547(b)(3) from the time that the shareholder became a creditor on June 5, 1979.

Knowledge of Insolvency under § 547(b)(4)(B)

Section 547(b)(4)(B) provides that the trustee may avoid any transfer of the debtor's property made between 90 days and one year before the filing date if the creditor-transferee was an

insider and had reasonable cause to believe the debtor was insolvent at the time of such transfer. Under § 101(25), an "insider" includes, if the debtor is a corporation, a director of the debtor, an officer of the debtor, and a person in control of the debtor. The shareholder was the debtor's sole shareholder at all times material hereto and was in complete control of the debtor. Both of the general partners were officers and directors of the debtor. The shareholder and its general partners were insiders for the purpose of § 547(b)(4)(B).

Under § 60b of the prior Act, actual knowledge of the debtor's insolvency or belief thereof was not

necessary, only reasonable cause to believe. Dougherty v. First Nat'l Bank, 197 F. 241, 246 (6th Cir. 1912); Dean v. Planters Nat'l Bank, 176 F. Supp. 909, 913 (E.D. Ark. 1959); 3 COLLIER, BANKRUPTCY ¶ 60.53[1] (14th ed. 1977). Factors that the courts considered in determining reasonable cause to believe the debtor to be insolvent included undercapitalization of the debtor, checks drawn on a bank account and payment refused by reason of insufficient funds, a consistent pattern of overdrafts, and operating losses. Dean v. Planters Nat'l Bank, 176 F. Supp. 909, 914 (E.D. Ark. 1959).

Nothing in the legislative history of § 547(b)(4)(B) indicates that the Congress intended to change the state

of the law concerning reasonable cause to believe the debtor to be insolvent. One commentator has concluded that because the reasonable-cause requirement retained for transfers to insiders is virtually identical to that under prior law, much of the case law under the former provision will still apply under § 547(b)(4)(B). 4 COLLIER, BANKRUPTCY ¶ 547.30 (15th ed. 1980).

The court has little difficulty in concluding that the shareholder and its two general partners had reasonable cause to believe that the debtor was insolvent at all times subsequent to June 5, 1980. Nolan not only was aware of the debtor's financial condition but rigidly controlled all of its financial transactions. He was aware in June

1979 that the debtor was severely undercapitalized, and that its bank accounts remained uniformly in an overdraft status. As an accountant, he must be charged with knowledge that the "equity in jobs" included on the debtor's balance sheet was not a viable asset for insolvency definition purposes.

Percentage of Creditor's Claim under § 547(b)(5)

Section 547(b)(5) requires a comparison between what the creditor actually received and what the creditor would have received in a chapter 7 liquidation but for the transfer. 4 COLLIER, BANKRUPTCY § 547.35 (15th ed. 1980). The court must focus upon the

relative distribution between classes as well as the amount that will be received by the members of the class of which the transferee is a member. S. REP. NO. 95-989, 95th Cong., 2d Sess. 87 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 372 (1977). The test under § 547(b)(5) is whether the creditor obtained from the debtor's property a greater percentage of his debt than some other creditor would have received under the distributive provisions of the Code had the transfer not occurred. 4 COLLIER, BANKRUPTCY ¶ 547.35 (15th ed. 1980). Whether a creditor had received a preference under the prior Act was determined not by what the situation would have been if the debtor's assets had been

liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the _actual effect_ of the payment as determined when bankruptcy results. _Palmer Clay Products Co. v. Brown_, 297 U.S. 227, 229, 56 S. Ct. 450, 451, 80 L. Ed. 655, 657 (1936); _Baranow v. Gibraltar Factors Corp. (In re Hygrade Envelope Corp.)_, 393 F. 2d 60, 64 (2d Cir.), _cert. denied_, 393 U.S. 837, 89 S. Ct. 114, 21 L. Ed.2d 108 (1968).

Although the Code does not define "class," the cases under the prior Act agreed that

> [c]reditors who, in the absence of preferences, are entitled to receive the same percentage upon their claims out of the estate of the bankrupt, are members of the same class. Those who are entitled to different percentages are of different classes.

Swarts v. Fourth Nat'l Bank, 117 F. 1, 8 (8th Cir. 1902). Holders of secured claims constitute one class, holders of priority claims under § 507 are in separate classes, and general unsecured creditors are in still another class. 4 COLLIER, BANKRUPTCY ¶ 547.35 (15th ed. 1980).

The shareholder is an unsecured creditor. The trustee demonstrated at trial that, after adding the total amount of the transfers herein at issue to the debtor's total assets, subtracting the total of all priority claims, and dividing the total assets by the total unsecured debt (including that owed to shareholder), unsecured creditors would receive .775054 percent of their indebtedness. The trustee

then attempted to show that, because of the transfers, the shareholder actually received .885750 percent of its indebtedness.

Although not challenging the accuracy of the trustee's computations, the shareholder asserts that § 547(b)(5) requires a determination that the net effect of all of the transactions between itself and the debtor was to deplete the debtor's estate and thus to interfere with the otherwise equal distribution of the debtor's assets among the debtor's creditors. The shareholder asserts that when otherwise preferential transfers are followed by extensions of credit that result in a net increase in the debtor's estate to the benefit of all of the debtor's

creditors, such transfers are not voidable preferential transfers as defined by § 547(b)(5). The defendants, in short, urge the court in its interpretation of § 547(b)(5) to adopt the "net result" rule that was applicable under § 60a of the prior Act.

The cases under the Act indicate that the "net result" rule that the courts applied under § 60a and the set-off provision of § 60c both arose from the close interaction between the changing provisions of § 57g and the first three subsections of § 60.

As originally enacted, § 57g of the Act provided that "[t]he claims of creditors who have received preferences shall not be allowed unless such creditors shall surrender their

preferences." Act of July 1, 1898, ch. 541, § 57g, 30 Stat. 544. Section 60a of the Act defined a preference as a transfer by the debtor while insolvent to any one of his creditors that would enable that creditor to obtain a greater percentage of his debt than any other of such creditors of the same class. Id. § 60a. Section 60b of the Act permitted the trustee to avoid a preference upon a showing that the transferee had reasonable cause to believe that the transfer had been intended as a preference. Id. § 60b. Because the debtor's insolvency was an essential element in the definition of a preference under § 60a, knowledge or a reasonable cause to believe that the transfer had been intended as a

preference under the Act ordinarily required knowledge or reasonable cause to believe that the debtor was insolvent.[3] 3 COLLIER, BANKRUPTCY ¶ 60.52[1] (14th ed. 1977). Section 60c of the Act provided:

> If a creditor has been preferred, and afterwards in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estates, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.

Act of July 1, 1898, supra, § 60c.

In McKey v. Lee, 105 F. 923 (7th Cir. 1901), the debtor had made payments within four months of the filing of his petition in bankruptcy to a creditor who had no knowledge of the

debtor's insolvency. The payments were made for goods and merchandise purchased during the same four-month period. Evidently presuming that the payments were preferences as defined by § 60a, the Seventh Circuit Court of Appeals held that, because the sale of goods to the debtor after the payments had amounted to further credit extended to the debtor in good faith and without security within the purview of § 60c, the creditor was entitled to set off the value of such goods against the payments and that § 57g required as a condition to the allowance of a claim only the return of the surplus. 105 F. at 925-26. A similar result was reached by the United States District Court for the Southern District of Ohio

in *In re John Morrow & Co.* 134 F. 686, 688 (S.D. Ohio 1901).

Subsequent to *McKey*, the United States Supreme Court in *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 438, 21 S. Ct. 906, 45 L. Ed. 1171 (1901), held that the trustee may not avoid a preference consisting of payments made within four months of the filing for goods and merchandise purchased on account during the same period of time when the transferee had no reasonable cause to believe that the debtor was insolvent and thus had no reasonable cause to believe that the transfer had been intended as a preference. The Court also held in *Pirie*, however, that § 57g of the Act required the surrender of even a

non-voidable preference as a prerequisite to the proof of any claim in bankruptcy. 182 U.S. at 447-55.

Lower courts immediately attempted to avoid the harsh result reached in Pirie. In Dickson v. Wyman, 111 F. 726 (1st Cir. 1901), which was decided less than six months later and which arose from facts similar to those in McKey, the First Circuit chose to avoid the effect of § 57g as interpreted by Pirie not by applying § 60c, but by finding that such payments, when considered together with subsequent purchases on a running account, are not preferences as defined in § 60a:

> While the supreme court has adopted a liberal construction of the statute in question, and we are bound to follow it, there must nevertheless be a limit to that method of interpretation . . . .

It is beyond all reason to hold, because a creditor has, in the ordinary course of business, during the four months preceding bankruptcy, received payments which under some circumstances might operate as a preference in some views of the law, that that fact can be held to bar the proof of his claim, when, looking at all the transactions together, they demonstrate not only that they were without any intention to acquire any unjust preference, but also that they have increased the net indebtedness to the creditor, and correspondingly increased the bankrupt's estate. In order to avoid so unreasonable a result, we might say that all the transactions covered by the account current should be regarded as one, so that it could not be held that the effect of the payments was to enable the creditors at bar to obtain a greater percentage of their debt than any other creditor of the same class, within the meaning of paragraph "a" of section 60. A result was reached under similar circumstances by the circuit court of appeals for the Seventh circuit in McKey v. Lee, 45 C.C.A. 127, 105 Fed. 923 . . . by giving a construction to paragraph "c" of section 60 beyond what its letter calls for; but we prefer to put the result on the

> broad ground that in the absence of positive and direct expressions, evidently intended to accomplish a particular purpose, the ordinary rules of construction require us to avoid interpreting this statute so as to effectuate so unreasonable a purpose.

111 F. at 728-29. A similar result was reached by the Eighth Circuit in Kimball v. E.A. Rosenham Co., 114 F. 85 (8th Cir. 1902), which held that

> the receipt by a creditor of payments upon an account current, in the usual course of business, which are followed by new credits for property delivered to the debtor, which becomes a part of his estate, for which the creditor has not been paid, and which equals or exceeds in amount and value the payments, does not constitute a preference, under section 60a, and does not require the creditor to surrender such payments as a condition of the allowance of his claim, under section 57g of the bankrupt act of 1898.

114 F. at 88-89. In Gans v. Ellison,

114 F. 734 (3d Cir. 1902), the Third Circuit held that nothing in Pirie prevented a creditor who had no knowledge of the debtor's insolvency from applying the setoff provided for in § 60c for the purpose of satisfying the requirement of § 57g. 114 F. at 736. The Gans court, however, adopted in the alternative the view taken by the First Circuit in Dickson:

> Upon the true interpretation of paragraph "a" of section 60, the preference in such case as this is the net gain to the creditor upon the transactions between him and the debtor. The net balance in favor of the creditor is the real preference under the law. For only to the extent of such net gain does the creditor "obtain a greater percentage of his debt than any other creditors of the same class." And so, on the other hand, only to the amount of the net gain to the creditor is the estate of the debtor impaired. If, then, a creditor innocently preferred has given return credits

> afterwards, he has surrendered his preference to the extent of such return credits. To effectuate justice, both sides of the account are to be considered in the case of a creditor who innocently has received preferences, and afterwards in good faith has given the debtor further credit, without security, for property which has become a part of the debtor's estate. Otherwise it is plain that such innocently preferred creditor would be compelled to surrender his preference a second time before he could prove his claim against the bankrupt's estate.

114 F. at 737. The court in Gans appeared to be concerned that any other interpretation would allow § 57g to accomplish the same result as § 60b even though the creditor had no knowledge of or reasonable cause to believe the debtor to have been insolvent:

> It is hard to believe that it was the intention of congress to put a creditor who had innocently taken a preference in a worse plight

> than a creditor who had knowingly done so. But to that conclusion we are asked to come. The appellant's argument runs thus: That although if the appellees had acted with guilty knowledge, their claims as allowed would stand; yet, having taken a preference ignorantly and in good faith, they cannot have the benefit of their subsequent credits which augmented the bankrupts' estate. Certainly a construction leading to a result so unreasonable is not to be adopted unless it is unavoidable by reason of the language employed by the lawmakers.

114 F. at 736. Relying upon the decisions in Dickson, Kimball, and Gans, the Second Circuit in In re Sagor & Brother, 9 Am. Bankr. Rep. 361 (2d Cir. 1903), likewise concluded that payments and sales under a running account in which new sales occur subsequent to the debtor's payments and in which the net result is to increase the debtor's indebtedness to the transferee do not

constitute preferential transfers under § 60a. The _Sagor_ court agreed with the court in _Gans_ that only when the net result of such transactions is a balance in favor of the transferee does the creditor "obtain a greater percentage of his debt than any other creditors of the same class" as required by § 60a. 9 Am. Bankr. Rep. at 367-68.

In _Jaquith v. Alden_, 189 U.S. 78, 23 S. Ct. 649, 47 L. Ed. 717 (1903), the United States Supreme Court followed the reasoning of the courts in _Dickson_, _Kimball_, _Gans_, and _Sagor_ and held that payments on a running account, when new sales succeed payments and when the net result thereof is to increase the value of the

debtor's estate, do not constitute preferential transfers under § 60a. 189 U.S. at 83. The Court's decision in Jaquith was reaffirmed in Yaple v. Dahl-Millikan Grocery Co., 193 U.S. 526, 24 S. Ct. 552, 48 L. Ed. 776 (1904), and in Joseph Wild & Co. v. Provident Life & Trust Co., 214 U.S. 292, 29 S. Ct. 619, 53 L. Ed. 1003 (1909). Although the transferees in each of these cases had in fact been unaware of the debtor's insolvency at the time of the transfers at issue, the Court did not premise its holdings upon a showing of lack of knowledge of insolvency.

Prior to the Court's decision in Jaquith and partly in response to the Court's earlier restrictive reading of

§ 57g in Pirie, the Congress in February 1903 amended § 57g to apply only to voidable preferences under § 60b and to certain other categories of transfers under § 67. Act of February 5, 1903, ch. 487, § 12, 32 Stat. 787. Arguably, therefore, the 1903 amendment of § 57g eliminated the theoretical foundation for the "net result" rule that the courts had developed in response to the decision in Pirie. Taylor, Section 60c of the Bankruptcy Act: Inadequate Protection for the Running Account Creditor, 24 VAND. L. REV. 919, 923 (1971). The doctrine survived, however, and developed a life of its own independent of its original purpose. In 1908, in what appears to be the first decision

after the 1903 amendment of § 57g, the Sixth Circuit, in determining whether a transfer by a debtor-partner of substantially all of his property to his son constituted a preference of one creditor over another of the same class justifying an adjudication in bankruptcy upon a petition by a partnership creditor, held that an adjudication is not warranted when the debt preferred is an individual debt and not a partnership debt. Mills v. J.H. Fisher & Co., 159 F. 897, 900 (6th Cir. 1908). In reaching this conclusion, the court declared,

> A preference under section 60a of the bankrupt act is only such when it will enable any one of his creditors "to obtain a greater percentage of his debt than any other of such creditors of the same class." . . . It is not a preference to make a payment upon

> a running account of purchases and payments, where the effect was not to diminish the fund to which the creditors look for payment. Jaquith v. Alden, 189 U.S. 78, 23 Sup. Ct. 649, 47 L. Ed. 717; Yaple v. Dahl- Millikan Company, 193 U.S. 526, 24 Sup. Ct. 552, 48 L. Ed. 776.
>
> 159 F. at 900.

In Federal International Banking Co. v. Childs (In re Fred Stern & Co.), 54 F.2d 478 (2d Cir. 1931), the bankrupt corporation had made payments to a bank, which had no knowledge of the corporation's insolvency, under a revolving credit agreement during the year preceding the adjudication. The trustee asserted that § 57g as amended required that the bank return the payments as a prerequisite to sharing in the distribution of the estate. The court held that the payments were not

preferential transfers as defined by § 60a:

> It is unjust to hold that, because the appellee has in the ordinary course of business during the four months preceding bankruptcy received payments which, under similar circumstances, might operate as a preference in some views of the law, it will bar the proof of this claim when, looking at all the transactions together, they demonstrate they were without any intention to acquire or to give any unjust preferences, and particularly where they have increased the net indebtedness to the creditor and effected a corresponding increase of the bankrupt's estate. In re Dickson, 111 F. 726 (C.C.A. 1). In order to avoid such an unreasonable result, it is proper to hold that all the transactions covered by this account will be regarded as one, so that it may not be held that the effect of any of the payments was to enable the appellee to obtain a greater percentage of its debt than any other creditor of the same class, within the meaning of the Bankruptcy Act . . . . The test in determining the absence or existence of a preference is whether or not the entire course of dealings on the

> open account, resulting from this revolving credit, resulted in the enrichment of the insolvent estate.
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> 54 F.2d at 480.[4]

Lack of knowledge of insolvency as an element of the "net result" rule appears first to have been required in In re Farmers' Store & Supply Co., 214 F. 505 (N.D. W. Va. 1914), in which two creditors with knowledge that the debtor company was "so involved in debt and bad management as to be unable to pay its debts, and therefore in the legal sense insolvent" attempted to put the debtor back on its feet by furnishing it on an open account with goods necessary to replenish its stock. The creditors within four months of the filing received payments from the debtor. The court concluded,

> It is clear . . . that merchants may sell goods to an insolvent customer, and may receive payments from him on account thereof within the four months prior to adjudication in bankruptcy, without such payments constituting a preference, provided the creditor so selling has no knowledge of the insolvency of his customer. If he has such knowledge, then such payments become preferential.

214 F. at 506. In In re Grocers' Baking Co., 266 F. 900 (M.D. & N.D. Ala. 1920), aff'd sub nom. Eggleston v. Birmingham Trust & Savings Co., 277 F. 1015 (5th Cir. 1921), the debtor executed promissory notes and mortgages to one of its creditors within four months of the filing in part as payment on a running account for supplies furnished for the purpose of allowing the debtor to remain in business. The court, in concluding that the transfers did not

constitute voidable preferences under § 60a, seemed to premise its holding upon a finding that the creditor had been unaware of the debtor's insolvency at the time of the transfers:

> [The creditor] believed, and had apparent good reason to believe, that the concern would be tided over a temporary embarrassment, and would, by the advancement made . . . be able to continue business and preserve the estate. [The creditor] subtracted nothing from the assets of the estate when [it] took the papers from the baking company. On the contrary, [it] added to the estate, by furnishing flour, lard, etc., for its operation, in harmony with the major purpose of making the notes and mortgages. To constitute a preferential transfer within the meaning of the Bankruptcy Act, there must be a parting with the bankrupt's property for the benefit of the creditor and a consequent diminution of the bankrupt's estate.
>
> It may be true that there was included in these conveyances a large amount of the property of the bankrupt, but the transaction

> was in good faith, with a view of preserving the estate and enabling it to continue as a going concern and to meet its indebtedness. Such conveyances were valid at common law . . . and, while Congress in the bankruptcy Act strikes down preferential conveyances, where the party has good reason to believe that a preference is intended, Congress has not declared voidable merely preferential conveyances made in good faith, if the grantee, as in the present case, was ignorant of the insolvency of the grantor and had no reason to believe that a preference was intended. . . . Payments on a running account, where is to increase the value of the estate, do not constitute preferential transfers under section 60a.
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> 266 F. at 909-10 (citations omitted).

Ignorance of insolvency was not required in Wilson v. Kanter (In re Marley-Morse Co.), 275 F. 832 (7th Cir. 1921). In Marley-Morse the debtor was in the mail-order grocery business. After the debtor had failed to fill

orders for several months, the debtor's ten largest creditors entered into an agreement with the debtor for an extension of their claims and for the appointment of a creditors committee to supervise the operation of the business. After entering into the agreement, the debtor continued to purchase goods from one of the creditors on a running account. The debtor made periodic payments to the creditor, and the creditor made subsequent sales to the debtor throughout the four months preceding the filing. The court, without making any finding as to the debtor's insolvency or to the creditor's knowledge thereof, concluded:

> [T]he record . . . discloses that the balance due the [creditor's] firm when the contract was made, instead of being reduced, became considerably increased. The record fairly warrants the conclusion that, in thus supplying merchandise after the creditors' agreement was made, it was upon the faith, not only that the concern would thus be saved from bankruptcy, but that such merchandise should not, upon being supplied, at once go to enhance the estate for the benefit of other creditors, but that, out of the proceeds of sales in due course of business, the merchandise thus supplied would be paid for. Such payments, under the indicated facts, are not preferential within the meaning of the law, and do not interfere with the allowance as a general claim of the entire debt, exceeding as it does the indebtedness to this creditor at the time the agreement was made.
>
> 275 F. at 833-34 (citations omitted).

Lack of knowledge of insolvency was required by the Third Circuit in <u>Campanella v. Liebowitz (In re Peter</u>

Cassinelli Macaroni Co.), 103 F.2d 252 (3d Cir. 1939). The creditor in the month preceding the filing delivered a carload of flour to the debtor in return for a thirty-day note. The debtor paid the note by a certified check within days of the filing. Without any discussion of the earlier courts' holdings that payments upon a running account when the net effect was to increase the debtor's estate did not constitute preferential transfers because they did not enable the transferee to obtain a greater percentage of his debt than some other creditor of the same class, the Court in Campanella reason that nothing in the earlier decisions indicated that the protection initially intended by the doctrine for

innocent transferees was to be extended to creditors on running accounts who had reasonable cause to believe that they were being preferred at the time the payments were made. 103 F.2d at 253. The court concluded that "any payment, received within four months of bankruptcy by a creditor who has reasonable cause to believe that the debtor-payor is insolvent, is a voidable preference and may be recovered by the trustee" under § 60b. 103 F.2d at 254, (emphasis supplied). A similar requirement was imposed by the Fifth Circuit in Cooper Petroleum Co. v. Hart, 379 F.2d 777 (5th Cir. 1967). On the first day of the four-month period preceding the filing of the bankruptcy petition, the debtor owed Cooper

Petroleum $34,599.83 for goods delivered on an open account. During the ensuing four months, Cooper Petroleum continued to deliver goods to the bankrupt on the account in the amount of $45,000. During the same four months, the debtor made payments on the account in the amount of $74,754.78. The District Court concluded that $34,599.83 of the $74,754.78 represented a voidable preference recoverable by the trustee. The Fifth Circuit reversed to the extent that the District Court had failed to find the remaining $40,154.94 to constitute a voidable preference. Rejecting the District Court's application of the "net result" rule when the creditor had knowledge of the bankrupt's insolvency,

the court in Cooper Petroleum reasoned that

> the Supreme Court decisions in which the rule arose as well as subsequent cases relying upon those decisions appear to have placed much more emphasis upon the creditor's lack of knowledge of the debtor's insolvency to justify application of the rule than upon any rationalization as to enrichment of the debtor's estate. . . . Indeed, several courts have persuasively indicated that where, as here, the creditor accepting payments on open account is found to have had reason to believe the debtor to be insolvent the rule is simply inapplicable, and all such payments, having been made in satisfaction of an antecedent debt, should be properly regarded as voidable preferences.
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> 379 F.2d at 780-81.

The decisions from two other circuits are to the contrary. In In re

Stewart, 233 F. Supp. 89 (D. Ore. 1964), a creditor within four months of the filing who was owed for gasoline already delivered to the debtor's station agreed to continue making deliveries if payments were made concurrently with each delivery. Each payment was to be applied to retire the oldest portion of the debt. The referee in bankruptcy held that the payments were voidable preferences. The District Court reversed and held that payments on a running account within the four-month period when new sales succeed payments and the net result is to increase the value of the estate do not constitute preferential transfers within the meaning of § 60a. The court observed that to hold otherwise

> would create chaos in that vast area of business relationships where the creditor has knowledge of the debtor's difficulty, but desires to assist in solving the problems by going along with the debtor on an arrangement similar to [the one presented here]. . . . [A] plan such as that, time after time, assists the debtor in putting his house in order, paying all creditors and making a success of his own venture. To treat such a transaction as a preference within the meaning of the bankruptcy act would be nothing short of placing a premium, or a brand of approval, on the actions of those creditors who do not attempt to assist the debtor, but on the other hand attach the property and thus force the debtor out of business.

233 F. Supp. at 92. In holding that such payments do not constitute voidable preferences, the court acknowledged that several of the early decisions were premised on a lack of knowledge of the bankrupt's insolvency at the time the credit was extended,

but expressly declined to follow the holding in _Campanella_. 233 F. Supp. at 92-93.

Consistent with _Stewart_, the Eighth Circuit in _Farmers Bank v. Julian_, 383 F.2d 314 (8th Cir.), _cert. denied_, 389 U.S. 1021, 88 S. Ct. 593, 19 L.Ed.2d 662 (1967), applied the "net result" rule, not to a running account, but to the substantial repayment of a bank loan within four months of bankruptcy that in turn precipitated a subsequent loan to the debtor. Within four months of the filing, the debtor repaid all but $3,000 of a $12,000 loan. This substantial repayment of the loan precipitated a subsequent loan of $16,000. The debtor received $13,000 in cash, of which sum $3,000

was applied to retire the balance owed on the previous loan. The court held that the repayment of the $12,000 loan was not a voidable preference under § 60a:

> When a creditor in good faith enriches a debtor's estate and this enrichment was caused by the otherwise preferential payment of an outstanding debt, the other creditors are only treated inequally to the extent that the preferential payments exceeded the new advances. If the new credit equals or exceeds the amount of the otherwise preferential payment the other creditors have not been harmed. Consequently, there is no recognizable preference under the equitable principles of § 60(a). How can it be said that one creditor is preferred over the others when immediately upon payment of a $12,000.00 loan the creditor gives the debtor an additional $16,000.00 in credits and assets? The net result of such a transaction is to enrich the estate of the bankrupt a total of $4,000.00.
>
> . . . Viewing the transaction as a whole . . . not only are the

> other creditors actually benefited, but the Bank received no greater share of the bankrupt's assets than it would had the bankrupt failed to satisfy the May loan.
>
> As these transactions do not interfere with an equal distribution of the bankrupt's assets among creditors of appellant's class, we believe the repayment of the $12,000.00 May loan did not result in a preference to the Bank as it precipitated new assets flowing to the bankrupt in excess of the amount of the payments.
>
> 383 F.2d at 328 (citations omitted).

The cases thus indicate that the "net result" rule under § 60a developed as a doctrine separate and apart from the setoff provision of § 60c of the Act. In order for § 60c to apply, there must have been a preferential transfer that was recoverable by the trustee. See Baranow v. Gibraltar

Factors Corp. (In re Hygrade Envelope Corp.), 393 F.2d 60, 65-67 (2d Cir.), cert. denied, 393 U.S. 837, 89 S. Ct. 114, 21 L. Ed.2d 108 (1968); Wertz v. Nat'l City Bank, 115 F.2d 65, 68 (7th Cir. 1940). The justification for the right to set off new credit against previous preferences under § 60c was the enrichment of the debtor's estate by the new assets added to it since the time of the prior preferential depletion. Atlas v. Eastern Yarn Mills, Inc., 27 F. Supp. 478, 479 (E.D.N.Y. 1939). The justification for the "net result" rule under § 60a, at least since 1903, was that payments upon a running account in which there were post-payment sales or extensions of credit did not constitute preferential

transfers at all, because the transactions taken as a whole did not enable the transferee to obtain a greater percentage of his debt than some other creditor of the sale class. Farmers Bank v. Julian, 383 F.2d 314, 328 (8th Cir.), cert. denied, 389 U.S. 1021, 88 S. Ct. 593, 19 L. Ed.2d 662 (1967).

The legislative history of § 547(c)(1) indicates that this exception was intended to codify "the net result rule in section 60c of current law." S. REP. NO. 95-989, 95th Cong. 2d Sess. 88 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 374 (1977). There is no indication that the Congress intended to effect any change in the separate "net result"

rule that the courts had developed under the definitional provisions of § 60a of the prior Act. The latter "net result" rule, therefore, will continue to apply under § 547(b)(5). Although § 547(b)(5) modifies the old greater- percentage test under § 60a to the extent that the court now must focus on the relative distribution between classes as well as the amount that will be received by the members of the class of which the transferee is a member, section 547(b)(5)(B) specifically requires a showing that the transfer enable the creditor to receive more than such creditor would receive if the transfer had not been made. Accepting the debtor's assets at face value, the trustee's computations might

very well accurately reflect that the defendants would have received a lesser percentage of their debt than would have been the case had the assets represented by the payments remained a part of the debtor's estate. This analysis neglects to consider, however, that the debtor's estate was increased to the extent that the extensions of credit by the shareholder exceeded the payments made by the debtor and that to this extent all of the debtor's creditors benefited from the transactions' having occurred.

The decisions have been confused and inconsistent on the issue of whether lack of knowledge of insolvency was a prerequisite to application of the "net result" rule under § 60a.

Ignorance of insolvency unquestionably was a factor in the origin of the rule as an equitable response to the harsh application of § 57g of the Act in _Pirie_. The rule, however, survived the 1903 remedial amendment of § 57g as an independent doctrine under the greater-Percentage test of § 60a. To have required an ignorance of insolvency as a prerequisite to application of the rule, therefore, would have been internally inconsistent with the other definitional elements of § 60a and, as a result, soon would have rendered the rule meaningless. Such a requirement likewise would be contrary to the definitional elements of § 547(b), which, except with respect to insiders, requires no showing that the transferee

had reasonable cause to believe the debtor to have been insolvent at the time of the transfer. With respect to insiders, such a requirement would render § 547(b)(5) incompatible with § 547(b)(4)(B)(ii) and thus for all practical purposes would eliminate the "net result" rule under § 547(b)(5) as applicable to insiders. Finally, such a requirement would be inconsistent with the fundamental purpose for the voidable preference provisions of the Code, which is not the imposition of a penalty upon creditors preferred by the debtor, but the equitable distribution of the debtor's assets among all creditors.

It is the court's opinion, therefore, that the transfers herein at

issue do not constitute preferential transfers.[5]

An appropriate order will be entered.

/s/ Russell H. Hippe, Jr.
RUSSELL H. HIPPE, JR.
Bankruptcy Judge

November 28, 1980
Nashville, Tennessee

1/ The court wishes to take this opportunity to correct a nonmaterial error in the first memorandum. In paragraph 12 at page 6 the court indicated that the secured creditors had perfected their security interests in the equipment sold by the debtor to the shareholder with appropriate filings in Kentucky. This was inaccurate as to the motor vehicles titled in Tennessee. The secured creditors' liens were not noted on the Tennessee title certificates, which had not been transferred to the shareholder. These security interests of the secured creditors' thus do not appear to have been properly perfected. Perfection of the security interests was not an issue, however. The trustee did not assert that he had any interest in any of the equipment as a creditor of the shareholder's.

2/ Section 547(b) proides:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor--
>
> > (1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made--

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer--

(i) was an insider; and

(ii) had reasonable cause to

believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if--

(A) the case were a case under chap- ter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (1979).

3/ The 1938 Act for the first time required a showing that the

transferee had reasonable cause to believe that the debtor was insolvent at the time of the transfer. 3 COLLIER, BANKRUPTCY ¶ 60.06[1] (14th ed. 1977).

4/ Concerning the "net result" rule as enunciated in Jaquith, Yapel, and Wild, Judge Learned Hand in a concurring opinion commented that "I am not sure that I understand on what principle those cases rest, but I cannot distinguish them on the facts." 54 F.2d at 481. In a dictum to a subsequent opinion interpreting not the Bankruptcy Act but the New York Stock Corporation Law, Hand observed,

> [I]t is true that at times when the debtor and the creditor have had a running merchandise account, begun after the debtor is insolvent, and ending in an enrichment of the estate, payments made upon the account are not treated as preferences. Jaquith v. Alden, 189 U.S. 78, 23 S. Ct. 649, 47 L. Ed. 717; Yaple v. Dahl-Millikan Millikan Grocery Co., 193 U.S. 526, 24 S. Ct. 552, 48 L. Ed. 776; Wild v. Provident Trust Co., 214 U.S. 292, 29 S. Ct. 619, 53 L. Ed. 1003; In re Fred Stern & Co., 54 F.(2d) 478 (C.C.A.2). The doctrine is somewhat anomalous at best, and can be defended in principle only by the fiction of treating all items of

the account as one and the payment as therefore subject to a set-off of the dividends payable on all. Even that will not serve unless the dividends exhaust the preference.

> Willcox v. Goess, 92 F.2d 8, 12 (2d Cir. 1937), cert. denied, 303 U.S. 647 (1938).

5/ This disposition eliminates the necessity for considering the defendants' reliance upon the exceptions provided for by § 547(c)(1) and § 547(c)(2), neither of which in any event appears to be available to the defendants.

In connection with the antecedent-debt requirement of § 60b, the courts uniformly held that a preference implies a paying or the securing of a pre-existing debt of the person preferred and does not extend to a transfer or to the giving of security for a substantially contemporaneous giving of new value. Dean v. Davis, 242 U.S. 438, 37 S. Ct. 130, 61 L. Ed. 419 (1917); Harper v. First Nat'l Bank, 169 F. Supp. 321 (W.D. La. 1957); Robertson v. Hennochsberg, 1 F.2d 604 (W.D. Tenn. 1824); 3 COLLIER, BANKRUPTCY ¶ 60.19 (14th ed. 1977). Section 547(c)(1) provides that the trustee may not avoid a transfer otherwise determined to be a preference to

the extent that the transfer was intended as and in fact was a substantially contemporaneous exchange for new value given to the debtor. Section 547(c)(1) adopts as an exception the well-established rule first enunciated in Dean v. Davis, supra. 4 COLLIER, BANKRUPTCY ¶ 547.37[2] (15th ed. 1980); Countryman, Bankruptcy Preferences--Current Law and Proposed Changes, 11 U.C.C.L.J. 95, 102 (1978).

In the light of the court's finding that each of the transfers herein at issue was for or on account of an antecedent debt owed by the debtor, the court likewise concludes that none of the transfers were substantially contemporaneous exchanges for new value.

Section 547(c)(2) provides for an exception to the trustee's avoiding power when a transfer was in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the creditor if the payment was made within forty-five days of the time of the debt was incurred, was made in the ordinary course of business or financial affairs of the debtor and the creditor, and was made according to ordinary business terms. The phrase "financial affairs" was included in § 547(c)(2) to ensure that consumer debts were brought within the purview of the exception. S. REP. NO. 95-989, 95th Cong., 2d Sess. 88 (1978); H.R.

REP. NO. 95-595, 95th Cong., 1st Sess. 37 (1977); 4 COLLIER, BANKRUPTCY ¶ 547.38 (15th ed. 1980). Section 547(c)(2) insulates ordinary trade credit transactions that are kept current. Weill v. Southern Credit Union (In re Bowen), 3 Bankr. Rep. 617, 619 (Bankr. Ct. E.D. Tenn. 1980); Levin, An Introduction to the Trustee's Avoiding Powers, 54 AM. BANKR. L.J. 173, 187 (1979).

Section 547(c)(2) was not intended to include transactions in the nature of those before the court in this proceeding. The payments herein at issue were not made to the debtor's suppliers and were not in the nature of regular business expenses. The court concludes, therefore, that the transfers are not subject to the exception contemplated by § 547(c)(2).

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

NOS. 81-5779, 81-5801

IN RE:	)
FULGHUM CONSTRUCTION CORPORATION,	)
Debtor,	)
ROBERT H. WALDSCHMIDT, TRUSTEE,	)
Plaintiff-Appellant, Cross-Appellee.	)
v.	)
HARRY RANIER, ALGIN NOLAN and RANIER & ASSOCIATES,	)
Defendants-Appellees, Cross-Appellants,	)

FIRST SECURITY NATIONAL BANK OF LEXINGTON and LIBERY NATIONAL LEASING COMPANY,

Defendants-Appellees.

Before: CONTIE and KRUPANSKY, Circuit Judges, and CELEBREZZEE, Senior Circuit Judge.

J U D G M E N T

ON APPEAL from the United States District Court for the Middle District of Tennessee.

THIS CAUSE came on to be heard on the record from the said District Court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the judgment of the said District Court dismissing the trustee's

complaint to avoid transfers from Fulghum to Ranier as preferential is hereby vacated and the case is remanded for further proceedings consistent with the opinion of this Court. The judgment of the District Court is affirmed in all other respects.

Each party to bear its own costs on this appeal.

ENTERED BY ORDER OF THE COURT
John P. Hehman, Clerk

No. 83-193

IN THE
Supreme Court of the United States
OCTOBER TERM, 1983

RANIER & ASSOCIATES, HARRY H. RANIER
and ALGIN H. NOLAN,
Petitioners,
v.

ROBERT H. WALDSCHMIDT, TRUSTEE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

---

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a decision of the United States Court of Appeals for the Sixth Circuit in this case holding that the judicially created "Net Result Rule" is not applicable to cases commenced under the Bankruptcy Reform Act of 1978, and that said doctrine has been codified as a "Subsequent Advance Rule" is correct.

PARTIES

The Petitioners statement relative to the parties is not disputed by the Respondent.

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---

BRIEF FOR THE RESPONDENT IN OPPOSITION

Robert H. Waldschmidt, Trustee, hereby objects to the petition of Ranier & Associates, Harry Ranier, and Algin H. Nolan for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit in this case relative to the preference action and the inapplicability of the "Net Result Rule" under 11 U.S.C. § 547(b).

OPINIONS BELOW

Respondent would incorporate by reference the statement relative to opinions below cited in the petition for writ of certiorari.

JURISDICTION

Respondent would incorporate by reference the statement relative to jurisdiction cited in the petition for writ of certiorari.

STATUTORY PROVISIONS INVOLVED

Respondent would incorporate by reference the statement relative to statutory provisions involved cited in the petition for writ of certiorari.

STATEMENT OF THE CASE

Respondent would incorporate by reference the statement relative to statement of the case cited in the petition for writ of certiorari.

REASONS FOR DENYING THE PETITION

The Petition for Writ of Certiorari should be denied because the opinion of the United States Court of Appeals for the Sixth Circuit is consistent with public policy, statutory construction, the legislative history, and decisions by other courts which have rendered decisions interpreting 11 U.S.C. § 547.

The Petitioners failed to cite in their petition any case decided by this Court construing or interpreting 11 U.S.C. § 547, and the Respondent is not aware of any such case. Therefore, the decision of the Court of Appeals is not inconsistent with any rulings of this Court.

The Petitioners argue that the "Net Result Rule" has been adopted by this Court in cases decided under the Bankruptcy Act of 1898. However, this case arose under the Bankruptcy Reform Act of 1978, which substantially restructured the law governing preferential transfers. The legislative history of 11 U.S.C. § 547(c)(4) clarifies the intent of Congress to modify the pre-existing "Net Result Rule" into a "Subsequent Advance Rule."

> If the creditor and the debtor have more than one exchange during the 90 day period, the exchanges are netted out according to the formula in paragraph (4).

Senate Report No. 95-989, 95th Cong., 2d Sess. (1978). The formula specifically limits this preference exception to advances made "after such transfer." Thus, the judicially created "Net Result Rule" has been eliminated by the Bankruptcy Reform Act of 1978, and has been replaced by the "Subsequent Advance Rule." *See* Ward and Schulman, "In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing", 61 WASH. U.L.Q. 1 (1983); 2 Norton Bankruptcy Law and Practice (1981) § 32.20; 4 Collier on Bankruptcy (15th Ed.) § 547.60; 16 WAKE FOREST L.R. 899; Queenan, "The Preference Provisions of the Pending Bankruptcy Law," 82 COM. L.J. 465, 476 (1977).

Bankruptcy courts in other circuits have developed the same approach to the "Net Result Rule" as that applied by the United States Court of Appeals for the Sixth Circuit. *In re Bishop*, 17 B.R. 180 (Bankr. N.D. Ga. 1982); *In re Garland*, 19 B.R. 920 (Bankr. E.D. Mo. 1982); *In re Rustia*, 20 BR. 131 (Bankr. S.D.N.Y. 1982); *In re Fabric Buys of Jericho*, 22 B.R. 1013 (Bankr. S.D.N.Y. 1982). Thus, the decision of the Court of Appeals does not create any conflict between the circuits that have ruled on the same issue.

Furthermore, the Court of Appeals observed that if the "Net Result Rule" were incorporated as a "judicial gloss" on 11 U.S.C. § 547(b)(5), as the Petitioners assert, the provisions of 11 U.S.C. § 547(c)(4) would be rendered meaningless. This court has previously ruled that statutes should be construed, if at all possible, in such a manner as to give all parts of the statute effect. *Jarecki v. Searle & Co.*, 367 U.S. 303, 81 S. Ct. 1579, 6 L. Ed. 2d 859 (1961); *United States v. Menasche*, 348 U.S. 528, 75 S. Ct. 513, 99 L. Ed. 615 (1955). Thus,

the Court of Appeals correctly ruled that the provisions of 11 U.S.C. § 547(c)(4) are controlling and that the "Subsequent Advance Rule" should be applied.

CONCLUSION

The decision of the United States Court of Appeals for the Sixth Circuit does not conflict with any decisions of the United States Supreme Court, does not conflict with any deicsions from other circuits, and is in accord with the Congressional intent of 11 U.S.C. § 547 and the principles of statutory construction set forth by the United States Supreme Court. Therefore, the petition of Ranier & Associates, Harry H. Ranier and Algin H. Nolan for a writ of certiorari should be denied.

Respectfully submitted,

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